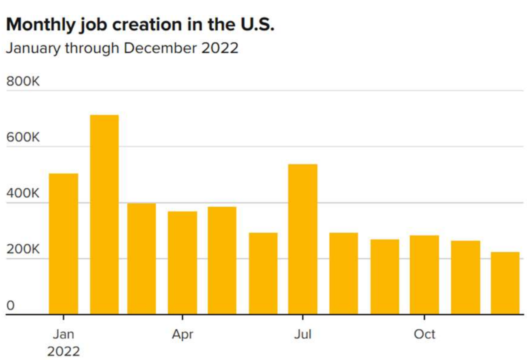
Expectations for the upcoming year

The quarter that just ended was an extremely complicated one as world markets and economic indicators plunged while inflation took the elevator. The talk of the town is that a recession could be unavoidable as the year ends and 2023 approaches and the conflict in Ukraine does not seem to ease creating new geopolitical instability.

United States

Even though the US economy has already recorded two consecutive quarters of negative economic growth last year and the university of Michigan's consumer confidence survey has dropped close to its lowest levels in 50 years, most economic data published in the third and fourth quarter of 2022 continued to highlight the resilience of the US economy. This resilience is particularly true for the labor market, with the latest employment and JOLTS (Job Openings and Labor Turnover Survey) reports showing plenty of momentum in the US jobs market as 223,000 payrolls jobs were added across the economy in December 2022, and job openings are hovering around 10 million as of last November.



The tight labor market is also generating substantial household income gains, with wage and salary income rising by 6.7% as of November 2022. On the inflation front, consumer prices saw a retreat to 5.7% in December of 2022 after a high of 6.7 in September. Back in March 2021 they stood at 1.5%. Markets performed well, reaching the current level of 33'000 from a low of 28'725 in September 2022. One explanation was the 10.5% decline in gasoline prices, while there were plenty of hotspots elsewhere, such as shelter costs, which rose by 0.7%. Overall, inflation is still expected to moderate in the coming months, but core inflation is expected to remain above the Fed's target. That said, the Fed's tighter monetary policy is already cooling down some parts of the economy, such as the housing market, as 30-year fixed mortgage rates have risen to well above 6%, their highest level since 2007. Consequently, housing activity data, such as existing home sales or the NAHB (National Association of Home Builders) homebuilder survey, have remained on a downward trend. This weakness has raised some fears of a repeat of the 2008 housing-led financial crisis. However, the housing market fundamentals are now much stronger as 95% of mortgages have long-term fixed rates while the percentage of subprime mortgages has dropped from 14% in 2008 to 2.3% today. Therefore, while we expect a continued slowdown in housing activity and economic growth, we don't expect a financial crisis. On a good note, the housing prices seem to have reached the bottom at the beginning of the year.

Europe

In Europe, the energy crisis continued to dominate the headlines as Russia completely halted gas flows through the key Nord Stream 1 pipeline at the start of September. However, what had been considered the worst-case scenario for Europe didn't lead to new highs in gas prices, which after having reached more than EUR 300 per megawatt hour in August dropped back to around EUR 200 by the end of the third quarter and back up to EUR 420 by the end of 2022.

As we detail in our latest note "Exploring the economics of Europe's energy crisis", the decline in European gas prices from their peaks can be explained by several factors, such as above-average imports of liquefied natural gas, which has helped the European Union (EU) to meet its target of filling 85% of the total underground gas storage capacity ahead of the current winter. Measures proposed by the European Commission could also help to ease tensions somewhat. The near-term EU proposals focus on three main areas: a plan for EU-wide electricity savings, with a broad target of 10% for general consumption; an EU-level uniform cap on energy prices; and a tax on the revenues of fossil fuels producers.

On the economic front, the situation continued to deteriorate during the third quarter, to the extent that a recession now looks like the base case. Most economic data published during Q4 2022 pointed to a slowdown, such as the euro area composite PMI business survey, which is now in contractionary territory. Industrial production dropped sharply in July (-2.5%) of last year, but recovered by the end of November (+2%) and euro area consumer confidence dropped to a new all-time low in September (-28.7), only to climb back to -20.9 in January 2023.

While growth has been decelerating in Europe during most of 2022, inflation, which has reached 10.6% year on year in October, retreated to 9% by year end 2022. In this context, the European Central Bank has become more hawkish, hiking its policy rate by 0.75% in September, and later increased it to 2% in December.

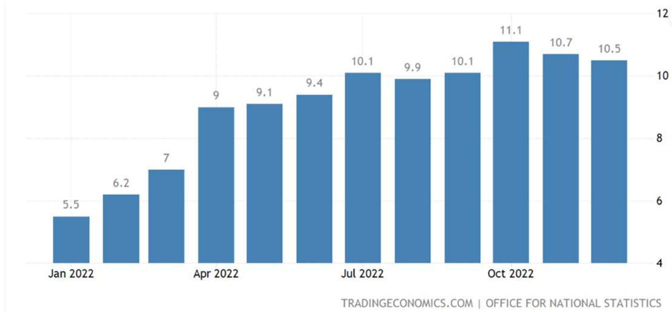
One surprise was the strong performance (+8%) of the German DAX index since mid-December 2022 up, perhaps signaling that the forecasted recession won't be that severe after all. The index is, a matter of fact, composed of mostly industrial, value stocks.

United Kingdom

In the UK, the death of Queen Elizabeth II, the longest serving monarch in its history, dominated much of the headlines over the quarter.

On the economic front, most data released in the quarter illustrated the loss of momentum in the UK economy. Consumer confidence fell to an all-time low in September and the PMI business survey dropped further into contractionary territory. The labor market remained a bright spot as the unemployment rate fell to 3.6% in July, its lowest level since 1974. However, on the back of the extreme tightness of the UK's job market, private sector wage gains surprised to the upside again, with the annual growth rate now running at 5.5%.

Inflation remained elevated in the UK last quarter and even though the headline CPI stands at 10.5% at December 2022, while core CPI increased from 6.2% to 6.3% year on year.



However, it was the UK's fiscal policy that attracted all the market attention as the new government announced a substantial unfunded fiscal package that will significantly increase government borrowing. Markets reacted very negatively to the announcement, with sterling falling sharply and Gilt yields increasing substantially. Borrowing costs rose so rapidly following the announcement of the fiscal package that the Bank of England was forced to intervene to purchase long-dated government bonds towards the end of September. Nevertheless, the 10-year Gilt yields still ended September at 4% compared with 2.2% at the start of the quarter.

China

The Chinese economy was confronted with several headwinds in the quarter, such as the country's zero Covid policy, weather-related disruptions, and lingering weakness in the housing market. However, while at the start of the quarter most economic data remained weak, the data started to improve throughout the quarter on the back of policy measures which supported fixed asset investment and industrial production.

However, China's economy remains fragile, as illustrated by weak credit demand. Weak domestic demand implies that China is not facing the inflation pressures faced by most other countries. Inflation stands at 1.8% at years' end.

This benign inflation environment allowed the People's Bank of China (PBoC) to ease monetary policy slightly by lowering its policy rate (the one-year medium-term lending facility rate) by 0.1% to 2.75%, and the one-year and five-year loan prime rates by 0.05% and 0.15% respectively. In addition, China's State Council, chaired by Premier Li Keqiang, announced new measures worth 1 trillion yuan, to support the economy.

The Zero-covid policy was finally lifted shortly before this past Christmas, sending a strong signal of hope for the overall local economy, as well as that of the entire planet.

What next?

As the fourth quarter 2022 just finished, the global economy should continue to slow while some economies could enter recession. The magnitude of this potential recession will partly depend on the effectiveness of measures deployed by policymakers to reduce the impact of the energy crisis on households and businesses. Central banks, confronted with the biggest inflation shock since the 1970s, will for their part probably continue to prioritize the fight against inflation over supporting growth. That means interest rates linger at high levels for a while, albeit knowing that we probably reached the high end.

Overall, while the growth outlook remains challenging, many stocks are now already pricing in a relatively high probability of at least a moderate recession. Government bonds are now also pricing in a significant amount of further tightening. After a very difficult year so far, for both stocks and bonds valuations now look more attractive for both. With the necessary dose of courage, it might be the time to jump into the investment’s arena, including the bonds’ market that has been neglected in recent years. Some major institutions believe that even in an unfavorable data environment, 2023 market should remain positive, with a little reserve for US stocks.

Marcello Tedeschi, Jan 25, 2023