Legacy Wealth Advisors

Investment Update

Summary of 2022 and Outlook for 2023

Market Wrap 2022

Inflation and monetary tightening were the key drivers for markets in 2022. It was quite an extraordinary year as the financial markets tried to make sense of the highest inflation seen in decades, rising interest rates and the war in Ukraine.

For investors, normal defences against the market downside didn't work. With the exception of oil, most asset classes had a negative return for 2022. Bonds ended up performing almost as badly as equities. The global aggregate bond index is down 15% year-to-date, and the S&P500 index is similar. With the exception of oil, most asset classes had a negative return for 2022.

Chart 1: Major Asset Market total returns for 2022 (% in USD)

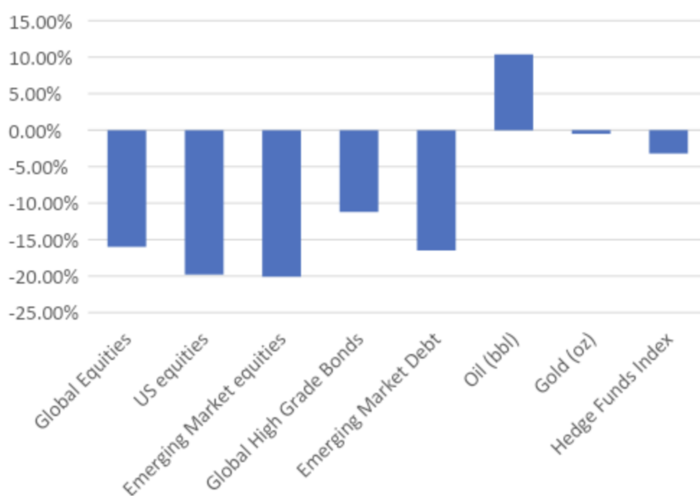


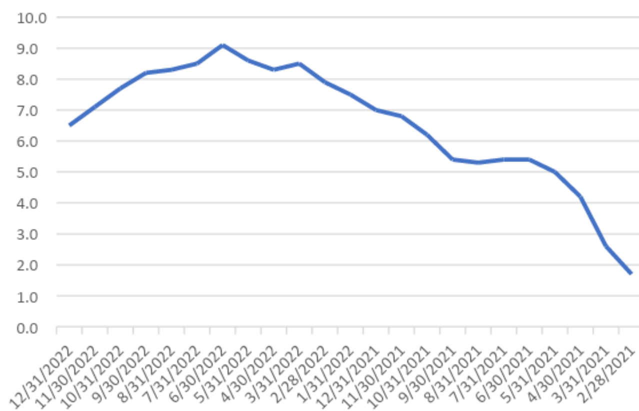
Chart 2: Global Bonds and Equities sell off – almost hand in hand

Source: Bloomberg

In the global economy, the surge of inflation, not caused by the war in Ukraine but exacerbated by the war, took inflation to levels not seen since the 1980s. Central banks were in a determined mood to bring inflation under control but were found lacking in the early days.

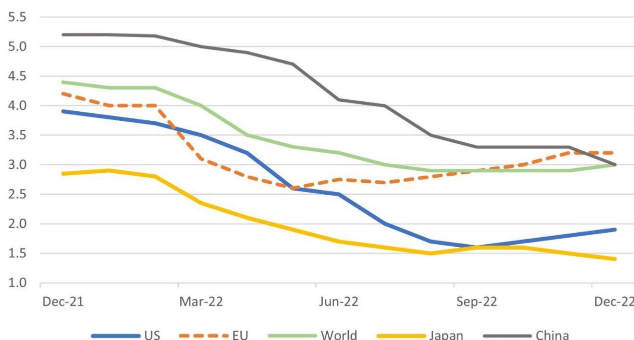
The Fed, ECB and the UK MPC have all had to accelerate their tightening of monetary policy in the latter months of the year. Bond markets were caught out, and although inflation is on a downward trend, there are still concerns among central banks that it may still be a few years before the battle with inflation is won. The US 10-year bond yield rose two percentage points to some of the highest yield levels since 2007.

Chart 2: US inflation rose to a multi-decade high



Global growth forecasts fell for the majority of the year before steadying in the fourth quarter. European growth forecasts were on the rise due to the massive efforts of governments to mitigate the effects of higher energy prices on consumers through tax breaks and direct payments to households. In Europe, government subsidies offered to households on their energy bills have helped keep consumer spending strong. In the central banks' eyes, growth equals inflation risk.

Chart 3: Consensus forecasts for 2022 GDP growth fell sharply before a modest recovery in Q4



Source: Bloomberg

In equity markets, non-US markets finally showed the outperformance that was much promised. Unfortunately, the substantial outperformance of European and Asian markets was overwhelmed by the dollar's strength. The Japanese equity market was down just 2% in local currency terms for the year but 17% in dollar terms.

Outlook for 2023

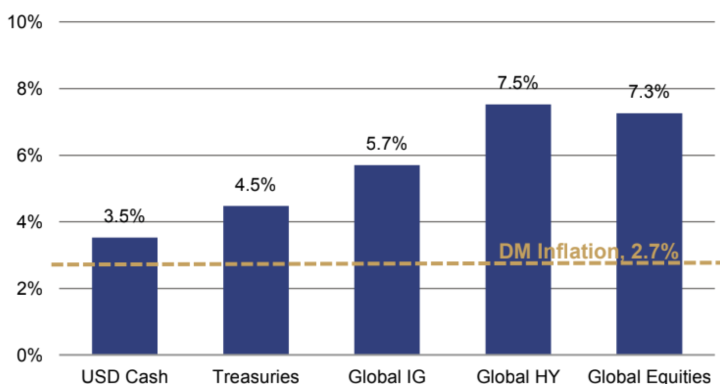
Looking for Opportunity

For much of 2022, investors often held outsize cash balances. The current sell-off in markets calls for a moderation of those cash positions. We would, however, be patient as far as buying back into the current markets. After all, the global recession has not even hit yet.

We are eyeing the bond markets in particular for early opportunities to invest. Although Central banks will keep pressing on the brakes until inflation is well within their target bond yields have risen to levels above which we might presume to be the long term inflation rate in many economies. Hence, a level of bond yields that offers a reasonable premium over long-term inflation represents value. At a couple of stages in the past six months, bonds yielded sufficiently to make them attractive. Ideally, a US 10-year bond yield above 3.75% is a good marker for value and saw active buyers jump in before. High-yield bonds that hit 9-10% represent good value, even assuming a pick-up in the level of defaults.

Equities – wait for the value to emerge.

Long-term valuations suggest that equity returns are expected to outpace even more elevated inflation. In view of this, equities are still the most attractive asset class for long-term wealth preservation.



Source: Rothschild & Co AG

However, investors will have to be patient with equities. We are likely to see the volatility continue and potentially more downside during the first half of 2023, before the markets settle down.

It would be quite a surprise to us if the equity market went on a sustained bull run without a marked slowdown in the global economy. At this stage, it is difficult to gauge just how significant a slowdown in growth we will need to bring inflation under control. For equity market valuations, the macro picture has two consequences. First, a drop in global growth must bring down consensus corporate profit forecasts; secondly, higher interest rates lead to a higher discounting of future profit growth and a lower valuation (PE) for equities.

The fourth quarter of 2022 showed that opportunities would come in the equity markets even during challenging times, but often from a value level. Chinese equities rallied 35% between the beginning of November and the end of December. Vietnamese equities rebounded 20% between mid-November and the first week of December. EU equities rose 15% between the end of September and the first week of December. These sharp movements suggest an investor appetite for equities but only from value/oversold levels of the market

As we enter 2023, there is an increasing sense that the worst might be behind us regarding the scale of the market sell-offs. However, there are still challenges ahead. Many economists forecast that a global recession will likely mark 2023. We doubt that analysts have taken this fully into their forecasts for corporate profits and therefore equities could still struggle in the coming months.

Central Banks – determined – so expect rates higher for longer

Central bankers, particularly the Federal Reserve, are determined to convince people that in their attempt to rein in inflation, they will increase interest rates to higher levels and keep the rates elevated for quarters and not just months. History is on their side, too. Inflation just doesn't disappear on its own. It must be squeezed out of an economy through sustained efforts over an extended period of time. For a monetary policy to be effective in bringing down inflation, necessitates higher unemployment and much slower wage growth than we see today.

Financial sector liquidity will be tested.

The recent problems facing the crypto markets are a testimony to what can happen when confidence is lost in the 'financial' institutions. The growth of the shadow banking industry, which has had much logic so far, has been phenomenal. In 2019, the size of the shadow banking industry was pegged at $52 trillion, a 75% increase since 2010. The lending sector has migrated partially to the collective investment sector, which comprises bond and hedge funds such as private credit funds. In 2019, the collective investment sector had grown by a phenomenal 130% over those nine years to $ 36.7 trillion.

While these companies and funds are often regulated, they do not face the same regulatory framework as a bank. For instance, some institutions in the US could take deposits from companies without affording any regulatory cover or compensation in the event of a failure. These institutions take in cash from corporations or borrow from investors. Any loss of confidence in the sector could precipitate a snowball of fund redemptions and liquidations, forcing these institutions to rein in their lending.

The good news is that traditional banks have been regulated into safer institutions today than they were during the financial crisis – hence the relatively robust performance of the banks through the past year.

Key Risks to Keep in Mind

Inflation: Staying higher and for much longer; we see 4-5% headline US inflation

We believe that inflation may be more problematic in 2023 than the market currently anticipates. While we accept that inflation appears to have peaked, we remain concerned that the market is still attributing a lower probability to inflation persisting at a level that will unnerve the global central banks. We already sense an inflation mentality that is influencing the mindset of corporations. Therefore, we do not believe that the price increases we saw through 2022 were a one-off. In our view, companies are now more inclined to increase prices annually or, at the very least, whenever they feel margins are under pressure.

Oil prices: Biased to the upside; more likely $100 than $50

Considering the supply-demand dynamics of the oil market, we believe oil prices are biased to the upside. Our view is driven by the following factors:

- Years of underinvestment in boosting productive capacity
- Little sign of the re-emergence of US onshore oil supply as a significant addition to overall supply growth
- The risk of Russia weaponizing the oil supply – withholding oil from the market to force prices higher
- A sharp recovery in the Chinese economy offsetting any downside risk to demand resulting from the weakness in the Western economies

An upside risk to oil prices could mean that an investment in the oil sector is a potential hedge against a critical risk for 2023 – that of higher-than-expected inflation.

Slowing growth proves a hard nut to crack – we see no substantial crack in growth in early 2023.

Despite the aggressive tightening by various central banks, global growth was generally quite robust in the latter stages of 2022. While that can't continue, growth in itself may not slow down that easily. The growing determination to spend on part of the people post the COVID lockdowns has prolonged the recovery and provided a solid boost to global growth.

End of Report

Sources: Legacy Wealth Advisors, Global CIO, Bloomberg