First quarter 2023
Date of report: December 30st 2022

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Quarterly Report

Our view on the markets

Paradigm shift

Investing in the coming years is going to be very different than it has been for the last two decades. Inflation will remain higher than it was, forcing rates higher and hampering central banks' room for manoeuvre.

Since Volker's rate hikes to tackle runaway inflation in the 70s, investors have enjoyed an almost miraculous environment in which to make a return on their savings. Gold standard, which had disappeared a few years earlier, gave free reign to money printing and the accumulation of debt. Globalisation, in conjunction with other factors, enabled emerging countries to join the global production process, lowering production costs (and thus increasing margins), boosting corporate profits and taming inflation. This was alongside massive deregulation and consistent intervention by central banks at the slightest problem, along with an endless decline in interest rates (which in turn encouraged more debt, both corporate and government alike). Add in declining geopolitical risk (fall of the Berlin Wall and many countries moving to capitalism and global markets, something China was also doing in its own way) and increasingly intense state intervention to mitigate recessions (COVID aid being the most extreme example), and we get an environment for investors that was truly magical.

We believe much of the above will not hold true in the years to come. In my humble view, 2022 is not merely a stop along the road; it is a turning point. To begin with, one of the previous mainstays—globalisation—is clearly being reversed. This is a process that had started some time ago, but the pandemic forced many to think carefully about the resilience of supply chains, not just their efficiency. Moreover, distrust between large blocs is on the rise. Russia, and particularly the change of course in China, are unlikely to be reversed any time soon. Populist movements are becoming more prevalent across the globe, which does little to help the free movement of people and goods. This inevitably leads to higher inflation. More so because central banks have to manage it with negative real rates, in order to try to reduce the burden of the astronomical accumulated debt, which makes inflation structural—at least for a long time to come.

The problem is that inflation is not only an issue when filling the tank or our shopping baskets. It is a real setback when it comes to investing. Ultimately, it is the enemy that must be defeated. Those who save are simply postponing consumption. If our savings grow less than prices rise, the result is a loss, however much it may appear otherwise. Taking out deposits at positive rates (at last) can be tempting. But if the rate we lock in is below the level of inflation (on average it is and will continue to be so to deflate debt), it is a bad investment decision. By historical standards, fixed income and equity are still not cheap. Many alternative strategies compare poorly with current interest rates. So how do we make the most of our savings? Attend the event we are organising on 26 January and we will try to answer this question and go into more detail on all of the above.

David Macià, CFA
CAAM Investment Director

Strategy

Asset allocation (2023 Q1)

Monetary	↑
Fixed Income	→
Equities	↓

Fixed Income

GOVERNMENT	
USA	→
Eurozone	→
INVESTMENT GRADE	
USA	→
Eurozone	→
HIGH YIELD	
USA	→
Eurozone	→
EMERGING MARKETS	→

Equities

USA	→
Eurozone	→
Japan	→
Emerging Markets	→

Commodities

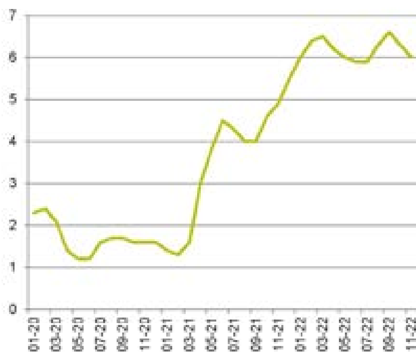
Oil	→
Gold	→

Currencies

EUR/USD	↑
JPY/USD	↑

Macroeconomic View

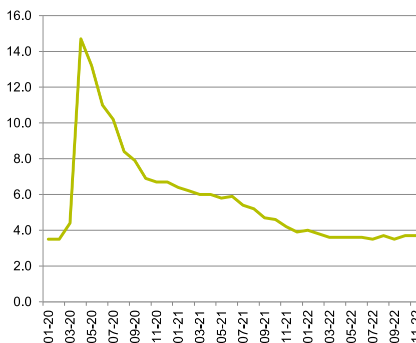
US CPI less food & energy



Source: Bloomberg

Although the consumer price index decelerated modestly into autumn, it remains well above central bank targets.

US unemployment rate



Source: Bloomberg

The unemployment rate remains at 3.7%.

US Average Hourly Earnings yearly growth rate

Source: Bloomberg

The year-over-year growth rate of average hourly earnings holds steady at 5.1%.

Expect a mild recession

Inflation probably peaked in 2022 and should improve going forward but it will remain at elevated levels. Financial conditions will continue to tighten, and we see the US entering a mild recession in 2023 due to rising unemployment. As for the Euro Zone, the region is struggling with the added burden of the energy crisis.

For a third year running, inflation is the key to determining where the economy is headed. Although the consumer price index decelerated modestly into autumn, it remains well above central bank targets and will likely be persistent. Encouragingly, some of the factors that fuelled inflation early in 2022 have started to fade. Prices of consumer goods have declined as supply chain constraints have eased. The price of oil has fallen back to January 2021 levels, thanks in part to a recovery in production.

However, the labour market in the US remains very tight and is still a long way from a level consistent with non-accelerating inflation and is adjusting very slowly. There continues to be a large imbalance between supply and demand for labour, with unemployment steady at 3.7% and the year-over-year growth rate of average hourly earnings at 5.1%. The combination of elevated job openings, low weekly claims data and robust wage growth all point towards the need for ongoing tightening of financial conditions. If the Fed is to curb inflation and avoid a price wage spiral, they will need to see an increase in unemployment. In that respect, and despite reducing the pace of interest rate hikes, we believe the Federal Reserve will not change course in 2023 and will not turn accommodative. The monetary authority is more concerned with avoiding the policy error of under tightening than overtightening.

Consumer demand is slowing, and it will slow further as excess savings start to run out and unemployment rises

Tighter monetary policy works by choking off demand, and that is starting to happen. The rate-sensitive housing sector is suffering the most and may already have entered a contraction.

Indeed, the excess savings that Americans stowed away during the pandemic have dwindled to $1.2 trillion from about $2.3 trillion, according to data from the Fed.

Euro area recession was likely already underway in the fourth quarter of 2022 as the region faces the additional headwind of the energy shock. The European gas market remains tight even though European countries have managed to lower their dependence on Russian gas imports by turning to Norway, the United States, and the Middle East, along with switching to alternative energy sources. On the positive side, inflation will likely fall thanks to additional energy price caps, firms' diminished pricing power and base effects.

Nevertheless, inflation pressures are weighing on corporate profits and consumers' real income, lowering investment and consumption. Labour markets should weaken due to the recession, further affecting consumer spending. Although the European Central Bank will probably have difficulties in reaching a consensus to raise interest rates in the face of slowing growth, taming inflation is more important in the long run than the short-term pain of a downturn.

Last year, we saw some of the consequences of higher inflation and the rise in interest rates on economic growth. However, tighter financial conditions act with a lag, and we have yet to see the full-blown impact as the economy benefitted throughout 2022 from a still strong consumer with a high savings rate and low unemployment. In 2023, the ramifications will be more apparent, and we expect to see negative growth on both sides of the Atlantic.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management and Institutional Accounts

Fixed Income

Pivoting between inflation and growth

And so ends the worst year for bonds since the 90s, due to central banks' rapid interest rate hikes to combat inflation exacerbated by the war in Ukraine. The outlook is now more optimistic for fixed income assets with bond yields at attractive levels from a risk-return perspective.

Central banks shook off the lethargy we had been accustomed to with their policy of zero or negative interest rates to combat their greatest enemy: inflation. And they did so globally and in a coordinated manner with a swiftness never before seen. In 2022, the Federal Reserve hiked its benchmark rate by +4.25% to 4.5%, and the ECB went from 0% to 2.5% by the end of December. Even the Bank of Japan decided to shift its level in the curve control strategy that it has maintained since 2016, opting to double the target cap for its 10-year government bond from (roughly) 0.25% to 0.5%. Looking to 2023, further rate hikes are still expected—at least at the upcoming meetings in February and March—of between 0.25% and 0.5%, depending on emerging economic data.

Inflation appears to be easing and central banks are getting closer to their terminal rates

Clear evidence of the effects of central bankers' efforts to fight inflation around the world is that bonds with negative yields are on the verge of disappearing. The global volume of these bonds is $250 billion today compared to $18.4 trillion just two years ago. The rise in interest rates has also caused notable incidents in 2022, such as the intervention of the Bank of England in buying Gilts to curb the financial panic in UK defined benefit pension funds, or the increase in mortgage rates that has affected house prices, particularly in Northern Europe, Canada and Australia. Other examples include the implosions of crypto-currencies and forced withdrawals in US SPACs.

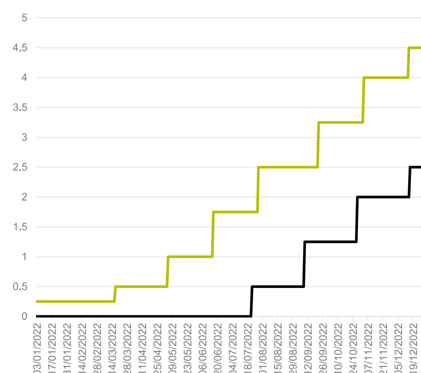
In 2023, after the adjustment of yields and spreads, we have a better starting point for fixed income assets. Bond yields are at levels not seen in a decade and they are already outperforming equity dividend yields, inflation seems to be easing and central banks are closer to their terminal rates. A new term has even been coined—"TARA: There Are Reasonable Alternatives"—for considering fixed income assets in new investments to be made.

The best time to go in for an all-in yield is likely to be in the first quarter with congestion in the primary as many issuers are bringing forward their new issuance programmes (for example, Germany announced a record issue volume for 2023 to help finance the support package for rising energy prices), and the claim that the euro zone will slip into recession. On this point, ECB Vice-President Luis de Guindos recently confirmed in an interview that the euro zone would fall into recession, although he underlined the view that it would be short-lived and shallow.

Investors have been pivoting between inflation and growth. When the Federal Reserve began to acknowledge that inflation was not transitory and started to raise interest rates, it had a negative effect on bond prices. Central Banks have aimed to influence demand to reduce prices, even causing an economic recession, in order to eventually bring inflation down. The 10–2 year spread of both the US and euro zone yield curves are inverted, which has traditionally signalled an economic recession. As long as the focus is on growth and not inflation, fixed income will perform well. We will see more inflows driven by its diversification factor and there will be a time when rate cuts by the central banks will start to be discounted in order to help boost growth again. In this scenario, fixed income should do better compared to other assets.

Josep Maria Pon, CIIA
Head of Fixed Income and Monetary Assets

Development of central bank benchmark rates (Fed and ECB)



Source: Bloomberg

The main central banks have raised their benchmark rates very quickly. The Federal Reserve raised them from 0.25% to 4.25% and the ECB raised them from 0% to 2.5% in 2022.

Bloomberg Global Aggregate index performance

Source: Bloomberg

Bond yields reach levels not seen in a decade.

Equities

S&P 500 2H 2022

Source: Bloomberg

The second half of the year saw two rallies that were ended by the Fed.

Yield of US 10 year Treasury

Source: Bloomberg

Equities have moved inversely to rates.

A year to forget

2021 saw all-time highs across equities, crypto, NFTs, and just about anything else that can be traded. 2022 was quite different as assets suffered under the combined weight of the Russia/Ukraine conflict, energy supply definitions, nuclear threats, spiking inflation, recession fears, the largest ever crypto fraud and the Fed.

Good riddance to 2022! The year ended with the S&P 500 down 19.4%, Russell 2000 shedding 21.6%, and the Nasdaq dropping an eye-opening 33.1%. The Nasdaq's performance was particularly painful as over the last several years, the outperformance of many Nasdaq stocks (including the mega-cap tech stocks) had led to many retail investors over allocating to what had become overvalued growth stocks. To wit, the mega-cap tech stocks had for years been considered safe havens among the equity markets, yet they were particularly punished as can be seen in the Vanguard Mega-Cap Growth ETF's plunge of 34%. Among the major US indices, the Dow Jones Industrials Average held up the best being down only 8.8%. Of course, the Dow Jones was buoyed by Chevron's 53% return and Merck's 45%. Both of these stocks were among the top gainers of the S&P 500 and they more than pulled their own weight within the Dow 30.

> "Recession is the most likely outcome", Alan Greenspan

Not surprisingly, the market suffered through a major correction in valuation as multiples compressed. At the start of 2022, the S&P 500 was trading at 21.5x forward earnings and ended the year trading at 16.8x. This is below the 10-year historical average of 17.1x, but the real kicker is that the 16.8x multiple is based off earnings estimates that many strategists believe is too high. Currently, consensus is that S&P 500 earnings will increase by 4%, but there is talk that the decline could be in the double digits.

At the top of this newsletter, we spelled out several contributors to 2022's poor performance, but let's focus on the one that receives the most blame. The Fed was reluctant to start raising rates in 2021 because it thought that inflation was "transitory." It belatedly admitted that it was wrong about inflation being transitory, but still held off raising rates in early 2022 because of the uncertainty created by Russia massing troops on Ukraine's border. The invasion commenced in February and triggered further inflationary pressure as panic spread through the global markets for energy and food. With such an uncertain economic outlook due to the war, the Fed continued to hold off until May when it raised rates by 50bp. This was followed by 4 increases of 75bp each and the Fed closed out the year with a final 50bp rise in December. This rapid rate increases were nothing less than the Fed acting in full panic mode as it tried to get inflation under control.

Unfortunately, the Fed's work is not yet done. Although inflation seemingly has peaked, it has not come down quickly enough. The market expects the Fed to raise by another 50bp in February and possibly again in March before potentially pausing. The February Fed meeting comes right before the 4th quarter earnings season. The 4th quarter reports are when most companies issue guidance for the upcoming year. We mentioned that earnings estimates for 2023 may be too high, and these reports will be the first real test of that. This could create a nightmare scenario of a still too hawkish Fed spooking a market right before an earnings reset. As awful as this scenario sounds, there could be some hope for better times later in 2023. The Fed will stop raising rates at some point in 2023 and earnings estimates will be reset to an appropriate level from which they can grow again.

Charles Castillo
Senior Portfolio Manager

Commodities and Currencies

COMMODITIES

Coming to the end of the storm

On these same pages, last summer we wrote that gas prices should normalise when the storm passes. At the beginning of 2023, we are not surprised to see that gas prices have indeed fallen by more than 60% from last summer's highs. The geopolitical storm has not yet passed, but we are at least coming to the end of it for the gas market.

Gas consumption in Europe fell sharply in December, not only because of the impact of milder weather conditions, but also because the mindset of private and business consumers has changed regarding the desire to use gas. At the same time, liquefied natural gas (LNG) imports reached a record high. As a result, stocks increased in the second half of December, which is rather unusual for the middle of winter. No wonder gas prices have plummeted.

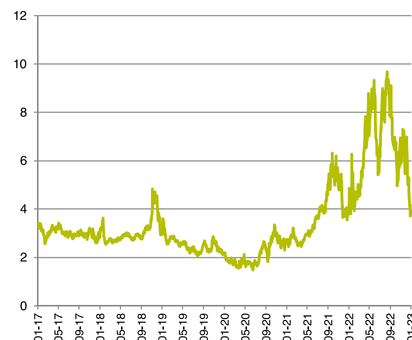
LNG imports increased compared to previous years. The US, Qatar and Russia (yes, Russia—which although down, still accounts for 18% of LNG imports) remain the main suppliers, but imports are also coming from Angola, Equatorial Guinea and Egypt. In addition, Spain is re-exporting its surplus gas to the European market.

Last year Europe ended the winter (end of March 2022) with 24% of stocks. Subsequently, operators managed to build stocks up to 96% by the end of October, which came as a relief as it was understood that we would avoid running out of gas in winter. If the trends of recent months continue, gas stocks would be at 51% by the end of March, meaning that not having imports from Russia would not pose a problem and we would go into winter 2023 with full stocks once more.

The storm for the gas market is coming to an end thanks to supply alternatives, and gas prices should also normalise at a level even lower than at present.

Miguel Ángel Rico, CAIA
Investment analyst

Natural Gas



Source: Bloomberg

Natrual gas slump.

CURRENCIES

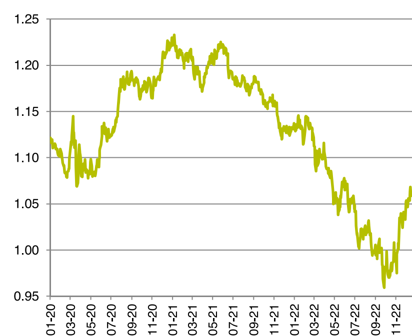
Has the dollar hit a turning point?

At parity against the euro, the dollar seemed expensive, but valuation is rarely a sufficient condition for an asset's price to change course. 2022 was the year of the dollar as it benefitted from a central bank that was the forerunner in interest rate hikes thanks to a more resilient economy, US energy independence, and the greenback's safe-haven status amidst market turmoil. However, after a 16% rally, the dollar started to weaken in October and cut its yearly gain by half. Different factors were behind this U-turn. US October inflation data came in lower, economic indicators pointed towards slower growth thereby underpinning a peak in inflation, the situation in Europe was better than feared and, above all, a reduced pace in interest hikes all helped debilitate the dollar.

A gulf remains between what the Fed says it will do and what investors are forecasting. Despite Powell's warnings, they are discounting a lower terminal rate and continue to think that the first rate cut may come as early as the summer. In short, policymakers and investors still differ over the most important questions. How persistent will inflation be? At what level will rates peak? And when will central banks pivot? Will America enter a recession? How these questions are answered will probably give you a good indication as to the direction of the dollar in 2023. Our belief is that inflation will remain well above the Fed's comfort zone, obliging the monetary authority to raise rates higher and keep them there for longer. 2023 is likely going to be a bumpy ride for most assets, the dollar included, and we would not be surprised to see the dollar strengthen yet again as the market comes to grips with reality.

Jadwiga Kitovitz, CFA
Head of Multi-Asset Management and Institutional Accounts

Euro dollar exchange rate



Source: Bloomberg

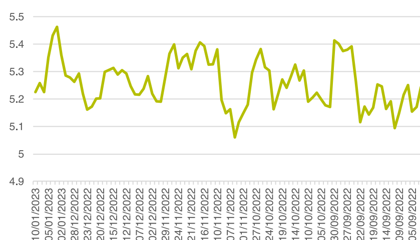
After a 16% rally, the dollar started to weaken in October and cut its yearly gain by half.

Latin America

Petroleo Brasileiro SA (PBR US)

Source: Bloomberg

USD/BRL



Source: Bloomberg

Old times in Brazil

Lula da Silva's first intervention decisions as president have rekindled investor distrust.

On 30 October 2022, in the second round of the presidential elections, Lula da Saliva consolidated the lead he gained in the first round. The gap between the leader of the Workers' Party and the outgoing president, Jair Bolsonaro, narrowed to less than two points, sustaining the uncertainty until the very end.

Investors, who were already expecting this election outcome, awaited the first economic decisions. Lula announced the appointment of, Fernando Haddad as the future minister of finance, provoking scepticism given his clear lack of technical experience in the field. Even more unwelcome was the approval in record time of the Law on State-owned Enterprises. This law, approved in 2016, aims to shield state-owned enterprises from political interference, following the Lava Jato scandal. He also reduced the bar on holding public office for members of political party structures from 36 months to 30 days, giving the all-clear to a government full of his most loyal supporters.

> The Bovespa closed the year in positive territory and the real was one of the few currencies to appreciate again

In Lula's inauguration speech on 1 January, he set out the pillars of this government: he announced his intention to eliminate the constitutional spending cap, the massive increase in the state's role in economic development and other measures such as the continuation of the fuel tax exemption, and a halt to the privatisation of companies. All this will certainly have a major impact on public accounts, and the market was quick to react. In the first session of the year, the Bovespa index fell 3.2% and the Brazilian real weakened against its peers, reaching one-month lows against the dollar.

Leading the declines was Petrobras, which has lost over 25% since the first round of the presidential election. The state-owned oil company was having a fantastic year, posting the highest revenues and profits in its history and handing out a record dividend of USD 28 billion. Bolstered by the global energy environment, it had left behind episodes of instability in its leadership, again caused by political interference. However, the interventionalist winds of the Lula government are once more raising the shadow of doubt over the company. The numbers are good and likely to remain so in 2023. Oil rigs account for 60% of production, where the breakeven is below $30 per barrel. They will continue reducing debt and the operational costs are under control. However, the weight of political uncertainty and instability is too great in a company with a long history of disappointment. We prefer to wait for more clarity on the government's plans for the company, but the qualities mentioned above make it worth having on the radar. As for the bonds, regular members of emerging bond investment portfolios, we believe they remain an interesting option.

Brazil survived what was a very difficult 2022. Its position as a commodity producer in an environment of supply shortfalls and its early action on rate hikes meant that, despite a socially turbulent situation, it managed to find favour with investors. The Bovespa closed the year in positive territory and the real was one of the few currencies to appreciate against the dollar. It remains to be seen whether these tailwinds are enough to withstand an economy with enormous political potential but that is also very fragile and dependent on public policies.

Juan Gestoso Ruiz
Investment analyst

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