February 2023

Economic Newsletter

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Investment Themes for 2023

There is large consensus among asset managers and economists that 2023 may bring further economic deterioration, led predominantly by the United States and other developed markets.

Mild recessions are predicted across much of the developed world. Furthermore, US inflation, whilst trending downwards, remains buoyed well above the Federal Reserve's target of 2%. As a result, US interest rates continue to rise, further stifling economic growth and placing pressure on markets.

In this newsletter, we unpack these key investment themes for 2023 and what they could mean for investment markets, and consequently for investment portfolios, over the course of the year.

Inflation & Interest Rates

Markets are now feeling the full effect of US Federal Reserve's failure to predict both the level and stickiness of inflation coming out of the Covid-19 pandemic. Subsequently, market forecasts and consensus estimates have routinely undershot the expected path of inflation. Even now, the market is pricing in a marked drop-off in inflation during the course of 2023, causing the Federal Reserve to pause its interest rate hiking cycle, and in some forecasts, to start cutting interest rates before the end of the year. Whilst this would certainly be a welcome relief to markets, we believe that inflation will again prove stickier than the market expects. With a target of 2%, and inflation currently running at 6.5% in the US, consumer prices still have a far way to fall to meet the Fed's objective. Whilst inflation is expected to moderate over 2023, we think a range of 3% to 4% is more likely.

Blackrock, the largest asset manager globally, recently published their 2023 Global Investment Outlook. In it, they too make the case for persistently higher inflation, stating, "We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years. More volatile and persistent inflation is not yet priced in by markets, we think[1]." They go on to call the market's view of falling inflation "wishful thinking", and as a result they maintain an overweight position to inflation-linked bonds, with the view that inflation will remain elevated.

The path of inflation in markets has a knock-on effect on the level of interest rates adopted by central banks. During 2022, in the face of the worst inflation outbreak since the 1970's, central banks reacted swiftly by aggressively raising interest rates beyond their neutral levels in order to rein in the soaring consumer prices. With interest rates now running at arguably restrictive levels, central banks, and indeed market participants, would relish the opportunity to pause interest rates and begin a policy reversal. A material drop in inflation would provide the relief central banks are looking for to put their policies on hold and start cutting rates.

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However, we think that a pronounced decline in inflation this year is unlikely, particularly to the 2% target level. If inflation remains elevated, central banks will be resistant to cut interest rates as doing so prematurely could cause inflation to rebound, leading to a much deeper recession in 2024. With this in mind, the probability of an interest rate cut in 2023 by Federal Reserve chair Jerome Powell is unlikely, despite what markets appear to be pricing in. A Fed pause in the second half of the year is a more likely outcome, but will also depend on inflation levels. If a pause were to materialise, it could likely trigger a brief rally in risk assets in response to the end of the hiking cycle.

Cloudy with a Chance of Recession

The combination of high inflation, restrictive monetary policies, and an inverted yield curve in the US all point towards a mature phase of the economic cycle. The key to forming asset allocation views over the course of 2023 is to determine whether the monetary tightening has been aggressive enough to push the US, and by implication most other markets, into a recession this year. Views surrounding the likelihood of a 2023 recession are somewhat mixed due to the current state of several recessionary indicators.

The largest factor underscoring the probability of a recession is that of interest rates. If the Fed remains aggressive, or hikes rates by more than anticipated, a recession is all but guaranteed. This view is held once again by Blackrock, who state that, "recession is foretold" due to the restrictive monetary conditions imposed by central banks. In a converse view, economic research conducted by the Macro Research Board puts the odds of a recession at 25% on the premise that central banks will be able to avoid overtightening their interest rates.

In the absence of outright central bank hawkishness, the US economy has proven to be reasonably durable. The American labour market continues to exhibit robust strength, with over 1.7 job openings for every one unemployed person. Similarly, the earnings outlook for the US market remains stable, and was slightly upgraded at the start of January. A Fed pause in the latter half of the year, combined with a strong labour market and resilient earnings, may well herald better than expected global economic growth.

As January reminded investors, selling out of equities prematurely can significantly reduce growth within an investment portfolio. We believe a diversified approach to portfolio management still holds true in these markets and will provide the best path to achieving your investment goals.

[1] Source: www.blackrock.com/corporate/literature/whitepaper/bii-global-outlook-2023

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