

Ten Seconds Into The Future. 2023 Outlook.

2022 was the first time since 1969 that equities and bonds fell in unison in a calendar year. The proximate cause of the declines was rising interest rates as central banks tightened financial conditions to rein in higher inflation. Rising interest rates affect both profitability and asset valuations via higher discount rates applied to future cash flows. The future of financial assets from equities to bonds and real estate therefore depends significantly on inflation and monetary policy.

I expect inflation will be structurally higher.

To understand why inflation might be higher in future it is useful to recognize why it had been so low in the last two decades. Globalization and in particular the rise of China as a manufacturing hub was responsible for keeping prices from rising too fast even in the face of steady growth. Unfortunately, the demographic dividend of China was already fading, sped up by the US China rivalry and decoupling. China will no longer exert the same disinflationary pressure as when it first opened up to international trade. No other nation has the potential to have the same disinflationary impact as China had in the last few decades. In addition, whereas the last few decades have seen a rise in globalisation and a focus on productive efficiency at all costs, notably resilience, the US China rivalry has accelerated a trend towards robustness and national self-sufficiency, a trend exacerbated by the COVID pandemic. Finally, efforts towards a more environmentally sustainable world will initially increase costs everywhere, an impulse that will fade eventually but not soon.

I expect that economic growth will be structurally higher.

The COVID pandemic has seen a global adoption of expansionary fiscal policy. While the pandemic has mostly faded and economies have recovered, fiscal support cannot be abruptly ended. At best a gradual phasing out will be undertaken. More likely, fiscal policy will now be an accepted policy tool. Expansionary fiscal policy is more redistributive which will lead to less unequal incomes and wealth. This is positive for the velocity of money and is supportive of growth.

At the same time, less expansionary monetary policy, an inflation response, redistributes wealth and income away from asset owners to labour which is also positive for growth.

The tendency of transfers from rich to poor and from firms to employees will have an equalization effect which encourages economic growth. The capital expenditure that the greening of the economy and self-sufficiency will require will further support growth.

The growth will be of higher quality.

Whereas the years 2010-2020 saw tepid growth and growth concentrated in corporate profits and a few narrow industries, the current and future progressive, redistributive nature of the confluence of monetary and fiscal policy is likely to promote a more balanced and broad based growth. The impact on innovation is hard to say. Higher cost of capital may limit experimentation but raises the hurdle for investment, encourages capital discipline and is less wasteful. A less unequal population is also a better resource allocator and can expect to yield better economic outcomes.

The fate of asset prices is obscure.

Higher growth rates may not translate to higher earnings. Corporate operating margins are at peak and likely to decline as labour's share of profits reverses a multi decade trend. Higher interest rates will struggle to support high equity multiples. Multiples contracting meets top line growth

with indeterminate outcomes. Higher debt service costs will directly erode the bottom line.

The shorter term is even harder to see.

Current trends have momentum and will likely overshoot long term tendencies. For example, inflation may fade from 7% to below 5%, where I think the long term sustainable average should be, to pre covid levels before rebounding to respect the fundamental picture drawn above. The Fed may ease too early and repeat the initial errors Volcker's Fed in the early 80s. Asset values are cyclical and volatile and could rise despite challenging fundamentals.

2023

Inflation is likely to abate further given base effects and a sharp retracement in commodities prices. Headline CPI is likely to hit 5% sometime during the year with an overshoot to 4% likely. The underlying pressures will not likely abate, and the labour market will likely be stronger than the Fed intends or the market expects. How the markets react to this complicated scenario is hard to predict.

Economic growth is strong and a policy induced recession, if we even get one, will be shallow. The Fed's rate hikes have inverted the short end sufficiently to induce a slowdown, however, the impulse of China's recovery from zero Covid could well compensate for the slowdown. A recession may be averted for a number of other reasons. Deglobalisation and environmental sustainability will encourage investment which would support growth. Even as monetary policy is moderated fiscal policy will remain accommodating even if less so than in the last two years. Fiscal deficits should continue for some time even if they are reduced. At best fiscal policy will maintain expenditure on the back of a more progressive tax code, an expansionary if budget neutral strategy. Even if we

do see a slowdown, the risk that the Fed cuts rates aggressively in response is low. I expect the Fed may tolerate slower growth and hold rates higher for longer than the market expects.

Fixed income. Duration.

Rates likely to remain elevated longer than the market expects. Rates are, however, close to peak and likely to close to a range of 5.00-5.25%. The risk is that the Fed may have to raise rates further than they planned or investors expect. Position net short duration being alert to signs of a reversal. Use any overshoot on rates on the downside to reposition long duration. Buy the USD curve steepener long the 2 to 5 year and short the 10 to 30 year. It's positive carry at a point of pretty extreme inversion from a historical perspective.

Credit.

Corporate credit will likely underperform. Operating margins are likely to mean revert as interest expense and labour costs erode profitability. Actual defaults are likely to be deferred for a number of years but markets will pre-empt distress. Investment grade bonds are preferred to credit sensitive high yield. However, markets will present unreliable exits and so it is important to have contractual or visible exits within a 2-3 year time frame. Generally, risks remain to the downside in corporate credit as spreads have not widened sufficiently to compensate for the risks. Bond market liquidity is also very variable and spreads need to widen further to compensate for this risk.

Household balance sheets remain robust. Consumer loan securitisations are positive relative to corporate credit. The long and steady rise in US housing provides strong collateral cover. The housing market will soften but as a result of expensive funding rather than over leverage and is a good

risk. Vanilla beta strategies may be sufficient to earn a decent return.

Equities.

Maintain an overweight value and underweight growth posture. The interest rate picture is still difficult for growth stocks. It's probable that we will revert to the conditions that underpinned French and Fama's 1997 paper on Value versus Growth.

Margin pressures will remain, less from materials but widening out to employment supply chain and distribution. The rate scenario cannot support elevated multiples and coupled with weaker earnings recommends a general underweight position in equities.

Beyond the US, Europe is already in stagflation. The implication for European equities is not straightforward as European companies are highly dependent on exports to Asia and the US.

China is difficult to invest in as policy is opaque and unpredictable. The reopening of the economy, however, clearly signals higher growth potential in the near term despite the initial and immediate spike in infections. Inflation is less of a problem in China and policy has more room to be accommodative. China is good for a short term trade perhaps lasting a year, maybe longer. In the long term, however, no command economy can compete with decentralized free markets.

India has been one of the best performing markets in 2022. One of the best strategies in 2022 has been to lie outside the main narratives of deglobalization, inflation and trade war, keep a low profile, be competent but unspectacular and stay out of trouble. The potential of the Indian economy is steadily being realized. The demographic dividend is paying off, the informal economy is being formalized and is being recognized as larger than previously thought, and the

acceleration to close the gap in per capita income to the likes of China recommend India as an investment opportunity.

Generally, the risks still lie to the downside. Valuations have retraced close to the mean but haven't overshoot, as they normally do whether rising or falling. Margins and earnings will come under pressure from inflationary input, labour and debt costs and liquidity conditions are likely to remain tight. Maintain an underweight position in equities.

Alpha opportunities are likely to be richer, although alpha can be negative; optimistic investors sometimes forget.