SALT **GLOBAL OUTLOOK** **January 2023**

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It's always darkest before the dawn

As we enter 2023, headline inflation appears to have peaked in many developed economies, though core inflation is expected to prove more stubborn as labour markets remain tight and wage growth in excess of the level consistent with mandated inflation levels.

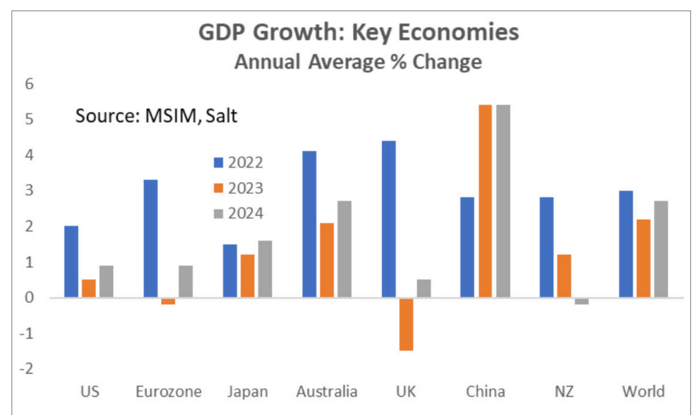
That leaves the critical question for 2023 as how much tighter monetary conditions need to become for central banks to believe they have done enough to constrain demand, rebalance supply and demand conditions in labour markets, and achieve their inflation objectives.

If 2022 was all about inflation and interest rates, 2023 seems destined to be the year of growth (more precisely the lack thereof), how far and fast inflation slows, unemployment, earnings, and credit risk. But with a nod to the forward-looking nature of markets, and with a lot of bad news already priced in, while this year will likely prove more challenging for the global real economy, it may yet prove to be a better year for markets.

Growth - Hitting the bottom of the cycle

Global growth slowed sharply in 2022 as the boost from Covid reopening faded, fiscal policy support waned, monetary policy tightened aggressively, growth in China was hit by the property slowdown and its commitment to Covid-zero, and Russia invaded Ukraine, sending energy prices sharply higher across the UK and Europe.

Growth will slow further in 2023 given the delayed impact of cumulative rate hikes to-date along with expected further interest rate increases in the early part of 2023. Global growth is likely to come in at 3.0% in 2022, less than half the 6.2% achieved in 2021. Consensus forecasts for 2023 are around the 1.5-2.0% mark before a modest but still below trend recovery in 2024.



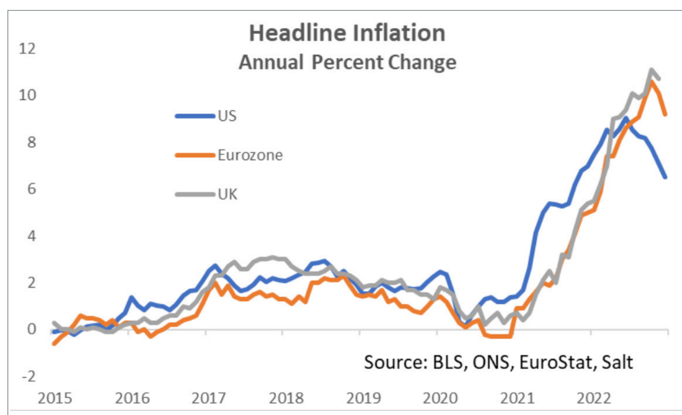
Most developed market economies will be in or close to recession in 2023. The consensus view is the US will narrowly avoid a recession, but with every rate hike the pathway to a soft-landing narrows. The UK and the Eurozone are likely already in a recession as the inflation hit from energy prices to real incomes has been more extreme. New Zealand will most likely be in recession from mid-2023, but growth is expected to remain positive in Australia.

Inflation to recede

We expect headline inflation rates to recede in 2023. Global headline inflation has peaked already, driven by an easing in global supply chain tensions and lower energy prices. Disinflationary forces are expected to broaden this year given lower commodity prices and further supply chain normalisation contributing to lower goods price inflation.

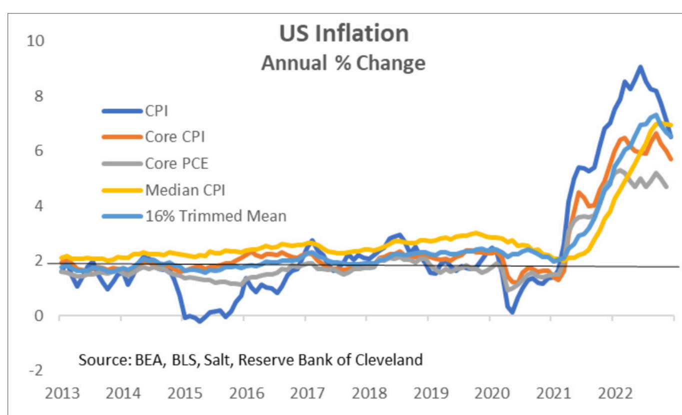
Services and non-tradeables inflation more generally are subject to domestic demand conditions, particularly the tightness of the labour market and wage pressures. Slowing demand and, in many cases, recession and rising

unemployment rates should see further easing of wage and core inflation pressures.



However, stubborn core inflation remains the greatest risk for central banks, growth, and markets in 2023. If core inflation remains too high, central banks will continue to tighten as they prioritise regaining their inflation fighting credentials over supporting growth.

Another risk is that given the aggression and speed with which central banks have raised interest rates, they fail to recognise or acknowledge the lags between raising interest rates and those rate increases having their full impact on the real economy. This scenario risks a harder landing for growth, the labour market and housing.



Labour markets remain key

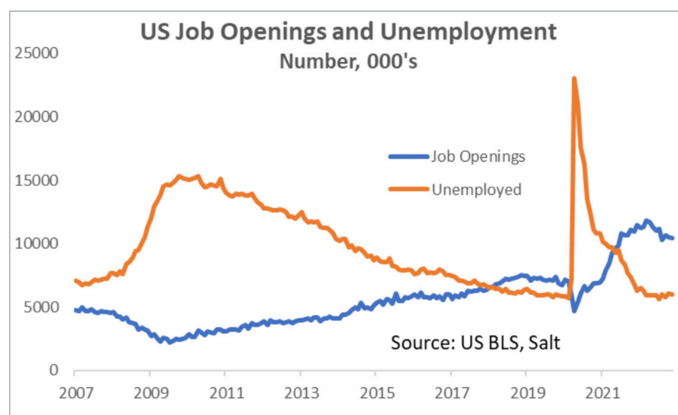
The largest input into the cost of services is labour, so the outlook for the labour market is critical to the outlook for services inflation and monetary policy.

The theory has it that tighter monetary policy slows demand which then in turn reduces demand for labour, reducing pressure on wages and eventually inflation. We have only seen tentative first signs of that equation as demand has softened in most countries to varying degrees. However, developed market labour markets remain tight, and wage growth remains high and inconsistent with 2% inflation mandates.

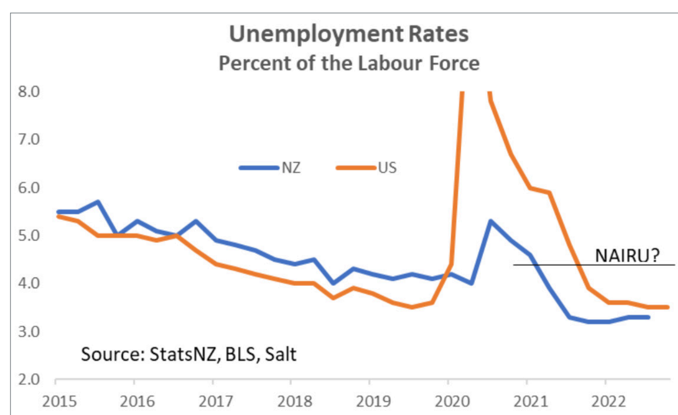
It's also important to acknowledge that monetary policy lags are longest in the labour market. It takes time for firms to adjust their workforce and employment intentions to tighter monetary policy and demand conditions, especially when we have come through a period of intense skill and general labour shortages. Firms will tend to hold onto labour for as long as possible.

In the next few weeks and months, markets and central banks will be looking for early signs of a softening in labour market conditions. One of the earliest signs will be a closing out of currently open job vacancies.

Data on this is generally poor in most countries, though the US is an exception with its Job Openings and Labour Turnover Survey (JOLTS). This survey showed US job openings peaked in early 2022 at 11.8 million. At the same time there were 5.9 million people unemployed, so two job openings for every unemployed person. By November job openings had reduced to 10.5 million with 6.0 million unemployed for a vacancy to unemployed ratio of 1.7.



Ultimately, central banks want to see lower wage growth which will require a greater balance between labour demand and supply. That means unemployment rates need to rise closer to NAIRU, the clumsily worded Non-Accelerating Inflation Rate of Unemployment. That level varies from country to country, but in New Zealand and the US, that level is thought to be around 4.5%, significantly higher than the current rates of 3.5% in the US and 3.3% here in New Zealand.



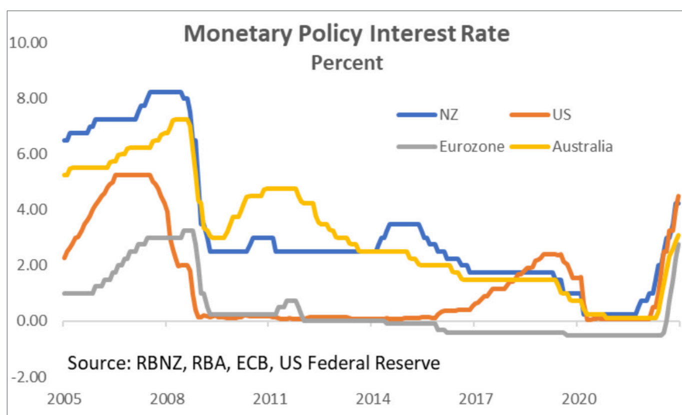
Markets took some heart from latest US employment data showing slowing but still solid employment growth, combined with lower-than-expected wage growth. This seems to suggest that a soft landing for growth with lower inflation is possible.

The cautionary note to that view is that US wage growth, at an annual rate of 4.6%, remains significantly higher than the level consistent with the Fed meeting its inflation objective. We put that level at 3%, assuming 2% inflation and generous 1% for productivity growth. We think the Fed will be thinking there will need to be more pain in the labour market before they can be confident of meeting their mandate.

Monetary policy – interest rate increases have further to go

Monetary policy was tightened aggressively through 2022 and terminal rate projections were revised upwards at regular intervals. At the start of 2022, the terminal Fed funds rate was projected to be around 3%. By the end of the year the median terminal rate dot in the now infamous FOMC (Federal Open Market Committee, the US Federal Reserve's rate setting committee) dot-plot stood at 5.1%.

While the FOMC, the Bank of England (BoE) and the European Central Bank (ECB) all stepped down the pace of rate hikes in their last moves of 2022, it was important not to take this as a sign that there was any greater clarity on their respective terminal rates. Indeed, at those meetings in December both the FOMC and the ECB signalled that a higher terminal rate than earlier signalled would be required to tame inflation.



So, there is still more work to do. We expect interest rates to peak, or at least pause in the early months of 2023. From there we expect interest rates to remain on hold until central banks have confidence that their inflation objective has been achieved. Some may need to resume rate hikes if the required slowdown in inflation isn't forthcoming.

Only when central banks have that confidence will they signal interest rate reductions. Market expectations that this could occur later in 2023 are optimistic. We expect interest rate reductions will be more likely a 2024 story.

A plethora of known unknowns

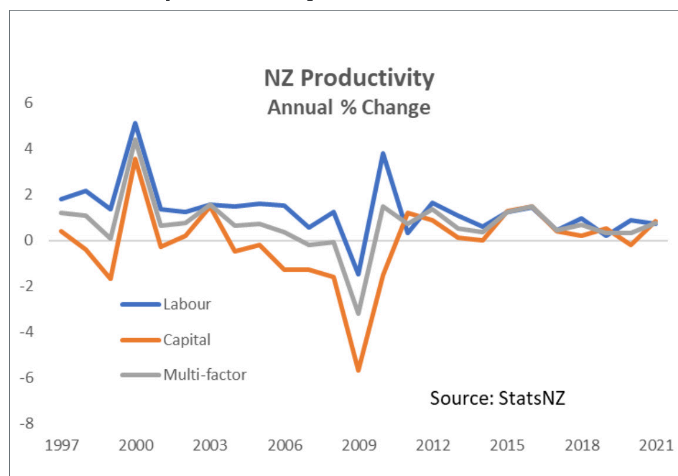
The uncertainty around the outlook for monetary policy is not new. While concepts such as potential growth, output gaps, neutral interest rates and non-accelerating inflation rates of inflation all appear to offer a sense of surety and suggest a robust framework in setting monetary policy, they are in fact all quite nebulous concepts, especially in real time.

Furthermore, they all change through time. For example, potential growth, or the rate of growth an economy can sustain that is consistent with stability in a central banks inflation mandate, is thought to have slowed over the last few decades. This reflects moribund productivity growth and slowing growth, or in some cases outright declines, in working age populations.

In another example, when the US Federal Reserve first started publishing estimates of the neutral Fed funds rate in September 2012, it was thought to be 4.2%. Their latest set of projections has it at 2.5%.

These concepts will continue to be a source of debate, especially as we enter this new period of greater economic volatility rather than the interest rate and cycle-repression that we have become used to over the last decade-and-a-half.

In our view, the downtrend in potential growth has continued. At the same time, as regular readers of our Insights will recall, we believe we are facing into structural forces that point to higher inflation in the period ahead. This includes the ongoing reversal of globalisation, in large part due to permanent shifts in global supply chains and a world of heightened geo-political tensions, structurally higher public debt levels, continued stagnation of productivity growth and the end of the era in which China acted as a key source of global disinflation.



The upshot is that we believe that neutral interest rates are on the rise. That's the long way of saying that when central banks do start cutting interest rates, don't expect them to go back to current estimates of neutral.

Growth risks to the downside

As growth slows across much of the developed world in 2023, the risks are balanced towards a more precipitous decline. These largely relate to the inflation and monetary policy risks outlined above.

Other risks that shouldn't be ignored are the potential for further commodity price shocks and geo-political tensions resulting in further supply chain disruptions. We talk about politics in the section below.

Related to monetary policy is the risk that our adjustment to higher interest rates, especially after such a long period of low and stable interest rates, becomes more problematic for asset prices. We are thinking this relates particularly to those assets that have inflated the most and beyond any reasonableness with respect to other fundamentals, such as residential housing.

We also remain concerned about high public debt levels, especially in an environment of increasing calls on the public purse to meet Net-Zero commitments by 2050 and fix problems like inequality. The experience of the last few months in the UK is that market reactions remain an important constraint on fiscal largesse.

Finally, and just to prove that economics doesn't need to always be dismal, there is the "risk" that all the imbalances in the world unwind far more quickly and less painlessly than currently anticipated.

China and Japan – facing their own issues

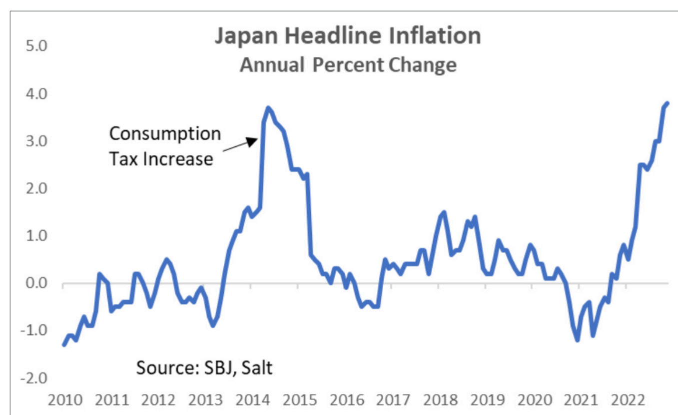
China and Japan have largely been immune from the high inflation and tightening monetary policy playing out around the world, but conditions in both have changed dramatically in recent weeks.

In China, the authorities held onto their Covid-zero approach much longer than anticipated. While most analysts, including ourselves, expected to see some relaxation of Covid restrictions following the conclusion of the National Congress of the China Communist Party (CPP) in October, the reopening has come more swiftly than anyone expected.

China's borders are fully reopening as we write this document. This will bring likely short-term disruptions in the form of sharply rising case numbers (and significant challenges for the health system), labour shortages and supply chain disruptions.

Longer-term, the relaxation of Covid control is consistent with our view of stronger GDP growth in 2023 of around 5%, up from around 3% in 2022. Covid aside, the outlook is not without risks including ongoing weakness in consumer spending and the precise details of support for the property sector.

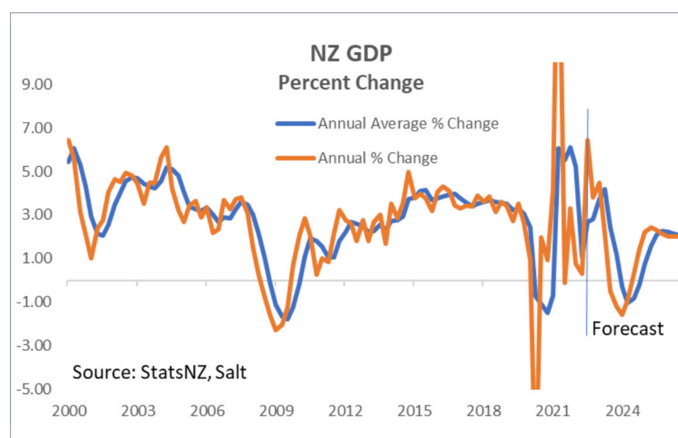
Meanwhile, the Bank of Japan, at its last meeting of 2022, sent shock waves through financial markets by adjusting its Yield Curve Control policy by widening the trading band around 10-year government bonds. Despite protestations to the contrary from BoJ officials, this was seen by markets as a de-facto tightening in monetary policy.



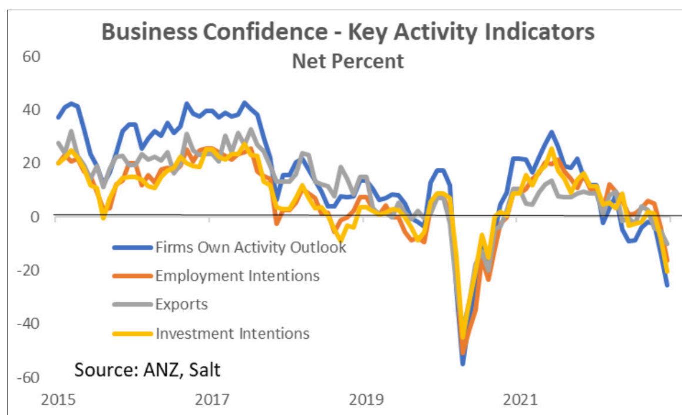
This is in line with our view that the BoJ would eventually be forced to adjust policy in response to higher inflation. The next move is likely to be a shift from NIRP (Negative Interest Rate Policy) to ZIRP (Zero Interest Rate Policy).

Demand conditions deteriorating in New Zealand

Persistent strength in New Zealand GDP data belies deteriorating demand conditions. The 2.0% q/q increase in GDP over the third quarter of 2022 continues to be influenced by Covid noise, particularly the reopening of borders. We have long signalled that the first "clean" GDP data wouldn't be seen until the fourth quarter of 2022, data that won't be released until the end of March.



At the same time as GDP growth remains surprisingly robust, business confidence as measured by the ANZ Business Outlook survey shows confidence at its lowest level since the 1980's. All key activity indicators are negative and heading downwards, including firms' assessment of their own activity outlook, export orders, and employment and investment intentions.

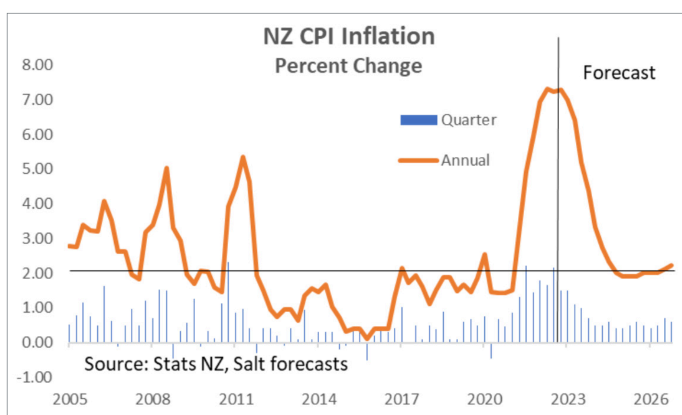


Weak business confidence alongside soft consumer confidence, the real income effects of high inflation, higher interest rates, low population growth, waning fiscal stimulus and a significant decline in house prices are all conspiring to more than offset the effect of returning tourists, higher wages and still strong (but waning) construction activity, resulting in a contraction in activity from the middle of 2023.

Headline inflation recedes through 2023

Along with our global view, we see the annual rate of New Zealand headline inflation moderating through 2023. Inflation likely peaked during the second half of 2022 at over 7%.

While inflation is expected to move lower this year, it appears likely it will still be elevated by the end of this year, at least in the context of a 1-3% target band. The Reserve Bank of New Zealand (RBNZ) is forecasting an annual headline rate of 4.8% in December 2023, and for inflation to only move back inside the top end of the target band in mid-2024. That is in line with our own view.

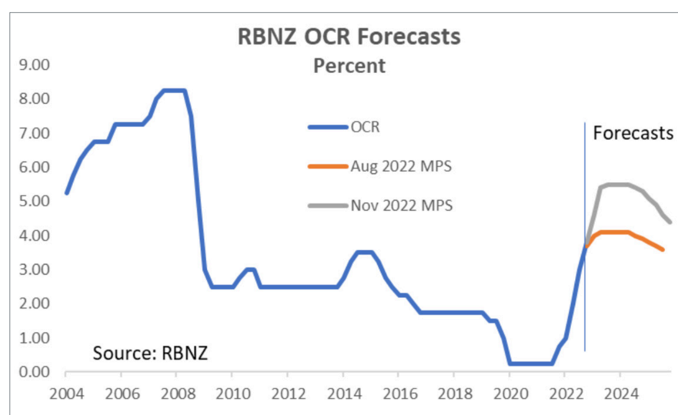


Again, consistent with our global view, we expect non-tradeable (services dominated) inflation to remain most sticky and problematic and a source of consternation and hawkishness from the RBNZ, at least until there are clear signs of weakness in the labour market and a reduction in wage pressure.

NZ Monetary policy

Counter to the trend towards a reduction in pace of rate hikes from the world's major central banks at the end of the year, the RBNZ delivered its most aggressive hike of the cycle thus far in November, increasing the Official Cash Rate (OCR) 0.75% to 4.25%.

While a hike of this magnitude was in line with market expectations, the RBNZ added to the hawkishness by disclosing they had considered a 100bp hike and surprised by lifting the projected terminal rate from 4.1% to 5.5%.



The RBNZ also signalled the need to engineer a recession to contain current inflation pressure. The question is what level of interest rates will be required to generate the said recession. As regular readers will know we were expecting a recession next year once our OCR forecasts got to 4%, for all the reasons outlined above.

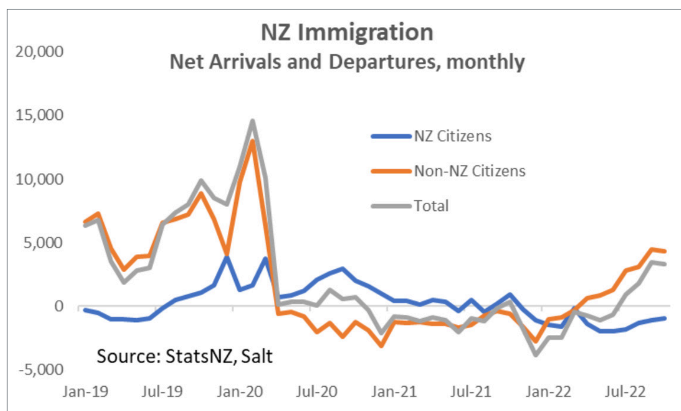
That begs the question as to whether the OCR needs to go as high as 5.5%. A key factor in this is the quantum of households on still very low mortgage interest rates for whom monetary policy hasn't yet tightened at all.

Two sets of upcoming data will be critical in the RBNZ's deliberation at next month's Monetary Policy Statement. December quarter CPI data will be released on January 16th and the Household Labour Force Survey for the same period will be released in early February.

Net migration turns positive earlier than expected

Another important development has been the earlier than expected turnaround in net migration flows. Net migration has turned positive earlier than we expected

it to. This occurred as the inflow of non-New Zealand citizens has accelerated more quickly than expected while the outflow of New Zealand citizens has slowed more quickly. The result is a net inflow of people into NZ over the last four months of just under 9500 people.



That has positives and negatives. A faster recovery in net migration adds to population growth and demand pressures in the economy at the same time the RBNZ is determined to bring demand and supply into better balance.

At the same time, rising net migration adds to the supply of labour in the economy and, assuming an appropriate skills match, a moderation of skills shortages and wage pressures.

Thinking longer-term, we remain of the view that strong inflows of migrant labour, particularly those with no or low skills, is not a solution for our long-term economic ailments such as low labour productivity. So, while it may provide a short-term solution, it is not the answer to some of our longer-term challenges.

Politics and geo-politics

Politics and geo-politics will remain centre-stage in 2023. In the first instance this will be observing the ongoing implications of some important 2022 developments including the return of the left-leaning Luiz Inacio "Lula" da Silva to the Brazilian presidency following his narrow defeat of the far-right Jair Bolsonaro, the precedent-defying appointment of Xi Jinping to a third term as China's President following the 20th National Congress of the Chinese Communist Party, a now divided US Congress, following the narrow Republican win in the House of Representatives following the 2022 mid-term election, and the ongoing Russia-Ukraine conflict that is about to enter its second year.

Fresh attention will focus on emerging markets this year with elections in Argentina and Turkey. Both have been plagued by high inflation and election campaigns will likely focus on containing inflation and putting the respective economies on a path to greater prosperity.

How the Russia-Ukraine conflict unfolds from here will be a key focus for markets in 2023. We don't claim to have any insights on how the conflict evolves from here, other than to note the conflict has gone on for longer than anyone anticipated, and that 2022 ended with Putin using more aggressive language and rhetoric when addressing the conflict.

Another potential geo-political risk we claim to have no special insights into is tensions between China and Taiwan. It is important to note however that potential sanctions of the breadth imposed on Russia following its invasion of Ukraine would be more problematic for a country as integrated into the global economy as China. That said, President Xi appeared to up the tension in his speech at the National Congress. We will continue to watch closely.

Finally, a general election is scheduled here in New Zealand later this year. Current opinion polls suggest a change of government is likely, but as the saying goes – a week is a long time in politics, let alone the best part of a year, so a lot can change and probably will. Issues likely to be at the forefront will be the usual suspects and a few new ones including the economy, interest rates, climate change, fiscal policy/tax, housing, crime, Three Waters, and co-governance.

Outlook for New Zealand Equities

The NZ equity market continued to defy the gathering storm clouds for the NZ economy and posted a solid return of +3.7% in the December quarter. This did however sharply lag the +9.8% advance posted by the MSCI World Index in the period.

NZ's move followed a +2.0% advance in the prior quarter but it was not enough to fully reclaim the weakness from the first half of 2022, which saw the market decline -12.0% for the year overall.

It would be a mistake to view the quarter as being one of broad-based strength. Only 14 of the 50 stocks in the NZ index outperformed and a number had special factors driving them. Key names were led by Fisher & Paykel Healthcare (FPH, +23.5%), whose result during the period suggested an earlier return to revenue growth than had been feared, with a bad flu season in the Northern Hemisphere being helpful for the utilisation of their equipment in hospitals.

Ebos (EBO, +16.7%) rose sharply based on forced passive buying activity as it was added to the MSCI World Small Cap Index. The forward valuation multiple of 28x forecast Jun23 earnings appears very full indeed but such are the ever increasing impacts of index changes on equity markets. Other stand-outs included a2 Milk (ATM, +20.6%) following improved guidance at their annual meeting and Pushpay (PPH, +16.4%) on confirmation after months of uncertainty that a takeover bid for the company would indeed be consummated.

Against an increasingly difficult economic backdrop, the reporting season in November was not as bad as may have been feared, with as many companies beating expectations as missing them. However, it did come with a raft of downgrades to forward years' forecasts, with outlook statements also containing a large amount of uncertainty. With inflation being an obvious risk factor, squeezed margins and interest rates were particular focus points rather than top-line revenue.

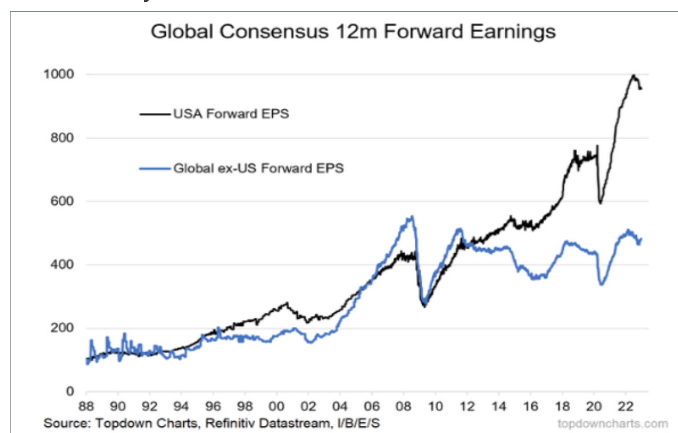
Our basic outlook for economies and investment markets is consistent with the view that we have propounded for most of 2022. Inflation is clearly peaking or has peaked and we are seeing some prices that adjust quickly such as shipping costs fall sharply. However, services sector inflation, which is closely linked to labour costs, is proving far stickier and will likely continue to be so given unemployment rates of circa 3.5% across NZ, Australia and the USA.

A key question for 2023 revolves around how persistent this inflation will be. We do not see how core inflation can fall back to the 2%-3% region targeted by central banks any time soon unless labour markets weaken materially.

The difference today, compared to early 2022, is that this situation is well understood and priced into markets. Two/ten-year yield curves are inverted across most key economies, with the debate being around the nuances of how long it takes inflation to decline.

The shock to equity markets in 2022 was the repricing from "Goldilocks" to this situation of durably higher inflation. US 10-year bond yields rose from 1.52% to 3.83%, Australia from 1.67% to 4.05% and NZ from 2.38% to 4.41%. We do not expect this shock to be repeated and think it likely that bond yields may range trade as they respond to actual inflation outcomes.

We believe different factors will likely drive equity returns in 2023. These will be "liquidity" as central banks use QT to drain cash from the system and the degree to which earnings forecasts are battered by slowing and potentially recessionary economic conditions.



The chart above shows that it is still early days in the global earnings downgrade cycle.

Research by Credit Suisse suggests that real EPS would need to fall by -12% just to get back to its long term trend of +4.2%/annum real EPS growth. Further, in a sharp cyclical slowdown, there is nothing to stop EPS falling below trend. It is also possible that trend EPS growth has declined given slowing population growth and the supply-side shocks from Covid, the Ukraine war and ageing demographics. It is interesting that while the US has seen strong EPS growth since its GFC trough, global EPS has been grinding sideways ever since 2008.

The situation in NZ may be worse. RBNZ Governor Orr is clear (for now at least) that a recession may be required to bring inflation under control. The monthly ANZ Business Outlook survey has turned in some dire readings. There is no survey in December but firms' year-ahead profit expectations weakened from -30.2 to -45.1 in November due to a nasty combination of rising costs and slowing revenues. Stunningly, this is even weaker than the -42.9 reading recorded in the grim post-GFC nadir in Jan09.

These business confidence readings are supported by consumer confidence readings having plunged to never before seen lows of around 73. This compares to past troughs of around 85 after the GFC and the brief March 2020 Covid plunge. 100 is neutral. If businesses and consumers act as they say they are going to, then Mr Orr may regret his desire for a recession. What the NZ economy desperately needs in 2023 are clear signs that inflation is declining back towards the 3% region. We are confident it has peaked but this may be a bridge too far.

While this all sounds rather dire and likely portends another tricky year for NZ equities, it is also information that is known and presumably is at least partially priced after two years of negative returns. Our assessment is that NZ equities are currently fair value at current interest rates at a median PE of around 16-17x. The key problem is that we do not trust the earnings forecasts and view further downgrades as being likely.

Therefore, our clear view is that more than ever, earnings certainty will be critical for stock selection in 2023. The performance of many cyclical stocks has been very poor over the last year or two but this is for good reason and may continue. There may well be a time to be brave and buy later in 2023 as the cycle reaches its nadir but we are not there yet.

In terms of what investors should own, we repeat our commentary from last quarter that it is worth looking at what worked in the stagflationary markets of the late 1970's and early 1980's. Two groups of stocks stood out. Firstly, those with secular growth drivers that are not affected by cyclical downgrades should do well, especially if bond yields have reached their highs. Secondly, stocks that are very cheap and had positive exposure to rising short term interest rates (insurers and banks) also did relatively well. Our view therefore remains that 2023 may be another tricky year for investors but that a bar-bell of secular growth and deep non-cyclical value may outperform.

Implications for Investors

After a turbulent end to a turbulent year, 2022's pattern of poor investment returns has challenged sentiment and led to elevated risk aversion in many quarters. With brief respites, most global asset markets, whether they be equities, bonds or metals, or non-USD currencies endured a grind downwards last year which has few precedents for breadth. In other words, 2022 was notable not only for the severity of price declines incurred by investment securities, but also by the range of asset types affected. It was the first year, since at least the 1870s, that both US stocks and long-term bonds fell by more than 10%, for instance. Fixed income markets were characterised by across-the-board selloffs, sparked by both duration exposure, as inflation surprised to the upside, and global central banks began raising rates, and by credit spread widening, as investors anticipated a slowing economy.

Equity markets were also seriously affected by the degree to which cost inflation and an end to "automatic easy-money" from global authorities left very expensive stocks highly exposed to downward correction. This was not surprising, given the scale of stimulus immediately prior to the inflation outbreak and the sharp removal of valuation support, as years of low earnings discount rates came to an end.

However, traditional assets have, as a result, re-entered a price range where the fundamentals-based investor no longer needs to overcome serious valuation reservations. It is now possible to re-establish suitable portfolio holdings at complementary diversifying weightings, making prudent portfolio construction more achievable.

New bases for long-term wealth creation

That is not to say that asset allocators should simply resume investing as they did prior to 2020. The extremely wide dispersion of returns delivered by different styles of equities in recent years argues for a re-think, focused on the actual objectives an investor seeks to achieve by holding securities, instead of simply accepting the yields on offer for deposits at banks and hoping that such exceed inflation rates.

The formerly popular approach of building portfolios from asset class proxies containing hundreds (and often, thousands) of individual securities led to an untenable reliance on broad multi-year rallies, to build portfolio value. However, such rallies may now be found to belong to a vanished era, where central banks cushioned or prevented recessions by expanding liquidity and lowering the cost of activity through interest rate suppression. Going forward, we are in a different environment where central banks are now attempting to induce mild recessions, to restore price stability.

It is likely that the period of "wave riding" investment strategy has now passed. Individual companies' characteristics, business models, debt levels, efficiencies and environmental opportunities or risks will determine investment outcomes which will be quite distinct from the returns earned on any broad market index. For instance, it is plausible to foresee a phase in which the main market benchmark indices move sideways in ranges, whilst individual securities within them still offer scope for better outcomes. We suspect that this is probable, throughout the year or more of economic cooling which lies ahead.

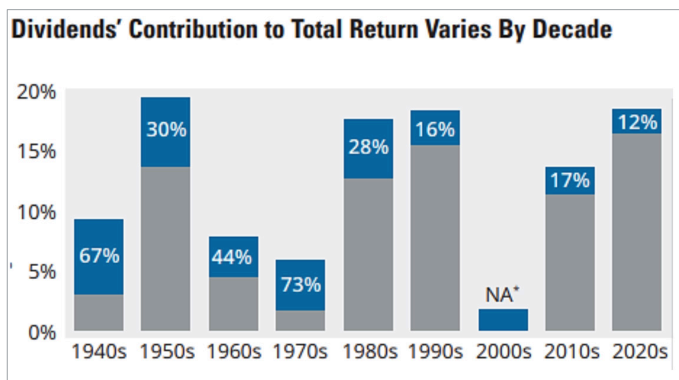
Therefore, our portfolios will remain focused on quality, sustainability, and diligent concentration in the best-positioned investable entities. The valuation of many of these assets has now become acceptable (in the case of selected Fixed Income) and compelling (in the case of Global Real Estate) when viewed on a multi-year investment horizon. In the wider Equity universe, defensiveness is to be valued as we enter uncertain times which will challenge profits for several quarters at least. Finally, as economies eventually exit the subdued period and re-embark on endogenous, non-inflationary growth paths that are not so reliant on liquidity stimulus, our portfolios will be advantaged by their focus on sustainable yield.

Portfolio yield is ever-important

Over time, the compounding merit of re-invested dividends should be a primary engine of asset accumulation and

in recent years, this historical norm was obscured by waves of pure capital gain, particularly in non-yielding equities. We are unsurprised that during the difficult year just passed, Dividend-oriented strategies proved more resilient – both in New Zealand and globally. Whether or not a shareholder dividend is any given managements' focus, the capacity of a corporation to meet the return on capital disciplines is a good test of operating quality.

Dividends have historically played their most significant role in total return, in periods when average annual equity returns were lower than 10% measured over the course of a decade. For the US market, for instance, the 40% average contribution (measured over 90 years) to total return furnished by dividends has been historically its most prominent during periods of inflation (the 1940s, 60s and 70s) which were also decades for which annual average total market returns were less than 10% p.a. Such an environment could easily characterize the mid-2020s and we aim to position portfolios accordingly over the next year.

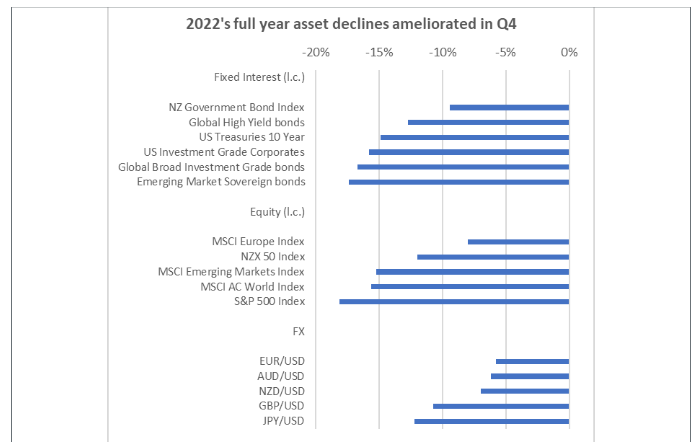


Source: Hartford Funds, Ned Davis Research Insight Q4 2022.

It is important to note that our approach certainly does not imply "dividend-chasing" at the expense of the sustainability of yield levels. In a potentially recessionary environment ahead (particularly in the domestic economy) there could well be dividend payout reductions to navigate. We are at an advantage in being able to access income from domestic and international securities, and are particularly confident in the valuable role to be played by listed real assets (infrastructure and property) in this regard.

2022's broad price losses were lessened in Q4

As the Fourth Quarter closed, a remarkable range of investment indices and exchange rates had logged declines of 10% or more, as the chart below shows. However, the end-year outcome was an improvement on the situation prevailing at the end of September, when key asset falls hit -20% year-to-date. Larger-than-20% declines in a plethora of assets were pared back, as sentiment stabilised.

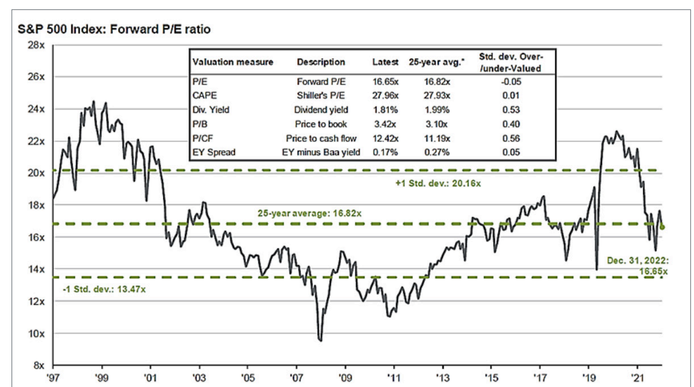


Source: Morgan Stanley, S&P Global (data to 31 December 2022, shown in local currency terms)

This shorter-term picture obscures the fact that over both 3- and 5-year periods to 31 December, international equities' annualised returns for New Zealand investors remain close to their long-run averages of 6% p.a. This contrasts with the situation for both NZ and International bond securities. The 3-year return from NZD hedged Global Aggregate bonds ended 2022 at -2.8% p.a., and the 5-year return at 0.1% p.a. - far below the 15-year average return of 4.7% p.a.

Has the Covid-19 share price bubble already deflated?

So, despite marked volatility, the pattern of returns from equities has in effect been returned to a long-run average level after a period of atypically-high annual returns (due to special monetary phenomena.) This development finds an echo in the forward-looking valuation estimated for the US equity market, which is shown in the chart below.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

Source: JP Morgan Asset Management (data to 31 December 2022)

The valuation levels of the MSCI World Equity Index and the US S&P 500 Index, have now returned very close to long-run average levels. For global equities, that level is 14 times, and for the US, 16.8 times forward earnings (on a 12-month consensus EPS estimate basis.)

The degree of restored "reasonableness" in current equity valuations is concealed somewhat by the still

above-average valuation level prevailing for the US market, because Europe and the UK, not to mention China and many Emerging Markets, have been trading at forward P/E ratios at the low end of their historical ranges. Of course, prospective corporate earnings may be still overstated, were a deep recession to develop in the course of 2023. Nevertheless, that risk is increasingly visible in market pricing.

A range of cost, demand and interest rate-driven headwinds are now expected to overshadow international corporate earnings for the 2023 year. On the other hand, since the global equity market reached Bear low points in mid-October 2022, it is important to note that substantial rebound rallies have been underway. As at the time of writing, in mid-January, the US S&P 500 had rallied 12% from its recent low three months ago, while the EuroStoXX 50 has gained a remarkable 24% over the same period. In the Emerging Markets sphere, MSCI China has soared 45% since October, and Hong Kong, by 36%. Of course, there remain several quarters of earnings downgrades and potentially disappointing corporate profit news ahead, so the prevailing monetary policy pivot-based optimism could prove premature and will face tests through the months to come, even as headline inflation figures gently diminish.

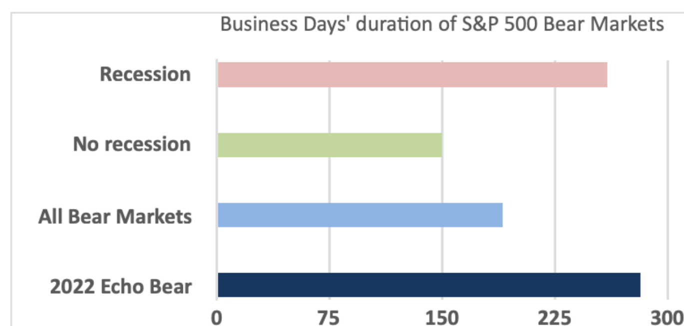
The "healthy revaluation" aspect of the Bear equity phase was central to its character and its likely future path. Our global equities partner Morgan Stanley Investment Management (MSIM) has been among the most cautious of the major international houses regarding equity market prospects, with consistently bottom-of-pack year-end Index targets, and skepticism about short lived market rebounds. However, the MSIM team have noted that over the next six months, more signposts will emerge that can determine the scope for a recovery later in 2023 for international share markets. They take a balanced view of the likely dynamics, as there are two scenarios depending on whether central banks manage to engineer a "soft landing," with growth trimmed but not crushed, in the fight to lastingly lower inflation risk.

Patience is endurance fortified by memory (Part II)

In our "Global Outlook" report last quarter, we commented that "the bear market in MSCI All Country World equities has lasted longer, and been more severe, than in prior episodes over the last 30 years. This indicates that for World equities, the greater part of the concentrated negative-returns period may be already passed."

Global equities' 2022 sell-off was certainly 'long-in-the-tooth' compared to an average bear market. Historically, bear markets tend to last around 9-10 months (or, almost 200 business days) but there is quite a difference between non-recession episodes and episodes accompanied by recessions (as subsequently defined by the National Bureau of Economic Research, the US cycle dating agency) tend to last four months longer. 2022's bear lasted the full year, with the S&P 500 closing 2022 -19.4% lower in price terms, and -18.1% lower in total returns (in USD,) just ahead of the MSCI All Country World Index (ACWI's) -18% fall. Put differently, by historical standards, the bear market period has been long, but comparatively shallow. Typically, using historical averages, a recessionary bear generates an average -34% return, compared to the peak-to-trough 2022 S&P decline of -26% at its worst moment (so far) on October 12th. At the time of writing, the US market has recovered 10% from its nadir, and is down -17% from peak.

2022's bear market was longest since 2007-09



Source: Morgan Stanley, Ned Davis Research

Of course, these negative returns were softened somewhat for unhedged NZ investors, with the decline in the NZ dollar over the period providing an offset, and resulting in a fall of a more palatable -11.6% for the year from the ACWI equity index in NZD terms. This was very close to the -12% annual return delivered by the NZX 50 Index last year. An undifferentiated return between International and NZ equity indices was not too surprising, given the role that policy interest rates has played in their support.

The divergence of the bear market duration is more extreme if we consider just US equities, for example the S&P 500 Index. Recessionary bear markets for US stocks last much longer than non-recession bears (which have just a 6 months' average duration) in the key US Index's historical performance. Furthermore, the peak-to-trough market decline in value terms is around 8% weaker in the recessionary episodes, than in the non-recessionary ones.

As MSIM analysts succinctly summarised at the end of last year's turbulent third quarter, "markets have actually already seen the degree of multiple de-rating and decline in consensus growth that's typical in recessionary bear markets. However, we've still not seen the negative earnings revisions or Equity Risk Premia widening that signals a 'normal' bear market, let alone a slowdown-related one." These are likely to keep the months ahead fraught, as with US and global growth forecasts still being revised downwards, it is difficult to credibly forecast that

the first half of 2023 will hold much better than mild corporate earnings declines (up to -0.5% for the S&P 500) while the full year's profit outlook is anaemic (+4.8%) and is likely to be lowered by analysts as the year progresses and more challenges come to light.

However, one should note that markets are forward-looking and at times can prove capable of looking through a degree of near-term profit weakness, if investors regain confidence that the medium-term future contains new catalysts for growth.

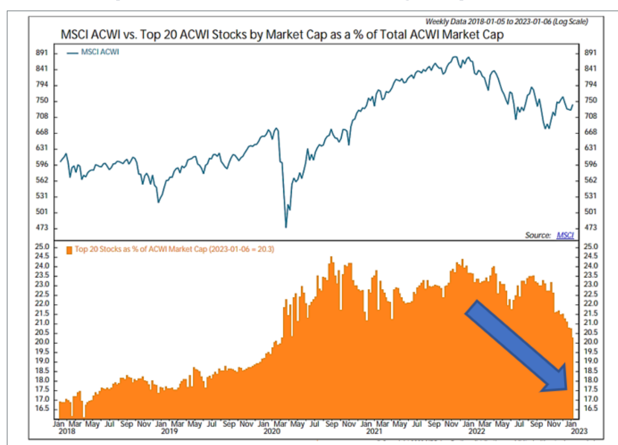
In the light of earlier comments on the value of dividend exposure, an interesting example is how the dividend-rich FTSE 100 index in the United Kingdom has defied the unenviable British domestic economic and political situation, with bond yields reaching multi-decade highs, and yet managed a positive return (in GBP) for the year of +4.6%. The UK index's resilience was also aided by a 10% fall in sterling against the US dollar and a 5% slide versus the euro, given the export exposure of large UK firms.

Less-narrow market and regional leadership is healthy

In the course of 2022, and particularly since the fourth quarter, there has been a notable departure in performance from what has typically characterised stabilisation-recovery periods in the previous era.

First, despite the recent downward move in long-bond interest rates and improving sentiment on the upward trajectory of monetary policy rates, the interest-rate sensitive technology stocks that have contributed greatly to the last few years' overall market direction have not yet resumed their prior dominance. The top 20 equity securities in the MSCI All Countries World Index (sized by market capitalisation) currently account for 20% of the total index value' compared to almost 25% at the height of Covid-19. Secondly, and closely linked to market cap, is that geographical regions outside the US are now experiencing stronger price gains than has been the case for five or more years.

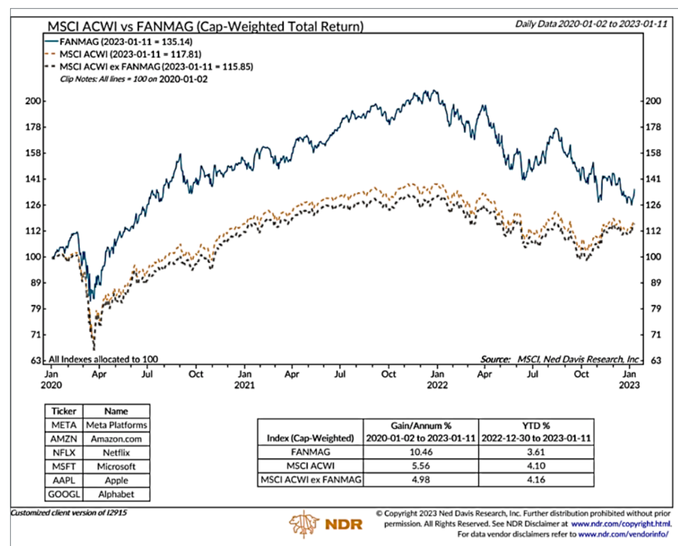
The bear phase also weakened MegaCap index dominance



Source: Ned Davis Research

The picture is more marked for US-domiciled stocks. The US tech giant FANMAG composite (Meta, Amazon, Netflix, Alphabet, Apple and Microsoft, repriced severely in 2022, declining by -38% from the end of 2021 until New Year 2023. These six enormous companies led the global advance from the Covid-19 bear market bottom in March 2020, until its high in December of 2021. Gaining 154% over the period, the composite pulled the ACWI higher by 97%, rising by 90% with the FANMAG stocks excluded.

While the price / earnings re-ratings in the FANMAG grouping were probably necessary given future uncertainties, perhaps of greater moment is that the deflation of hyperbole surrounding all emergent technology and on-line activity (particularly in the crypto currency and virtual reality arenas) has enabled a resumed focus on valid business models and the robust compounding of earnings streams. Investing in companies with true pricing power is crucial because earnings should be relatively resilient in a squeeze on the wider market's profitability.



Ticker	Name
META	Meta Platforms
AMZN	Amazon.com
NFLX	Netflix
MSFT	Microsoft
AAPL	Apple
GOOGL	Alphabet

Index (Cap-Weighted)	Gain/Annum % 2020-01-02 to 2023-01-11	YTD % 2022-12-30 to 2023-01-11
FANMAG	10.46	3.61
MSCI ACWI	5.56	4.10
MSCI ACWI ex FANMAG	4.98	4.16

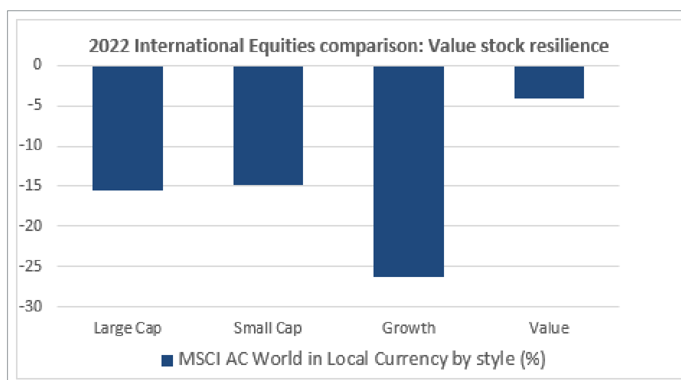
Source: Ned Davis Research

We thus fully endorse the comments of our team of Sustainable International Equities specialists at Morgan Stanley Investment Management, when they wrote that while "current derating of some stock P/E ratios has reduced, but not completely removed, the multiple risk, we believe the major threat to earnings in the short term is the prospect of an economic slowdown as central banks continue to attempt to counter inflation through higher rates. The pace may differ by region. Longer term, there could be further pressures on earnings, such as the need to build more resilient supply chains or potentially higher corporate tax rates as governments look to repair their finances.

Given the uncertain macroeconomic landscape and the room for policy errors, we continue to advocate for a portfolio of high-quality compounders. The combination

of these companies' recurring revenues and pricing power should protect revenues and margins in a downturn, providing asset owners with earnings resilience and relative predictability through tougher, more volatile times."

Resumption of Value stock attractiveness should continue into 2023



Source: Morgan Stanley Investment Management

Corollary to the points above, is the observation that after years of underperforming their pure "Growth" counterparts, the altered economic landscape in 2022 allowed some better performance from the "Value" segments of the international equity universe. Whilst care is always required in identifying value characteristics, it is probable that selected financials and high-quality compounders others with recurring revenues will provide safer exposure to the next macroeconomic and investment phase. Such stocks are not always "cheap" in the price ratio sense, but their qualities of steady growth can lead to periods of market lag and active management is able to enter long-term positions at more attractive prices. This is analogous to the "Berkshire Hathaway" model of investing but has even greater sensitivity to re-invested earnings and return on capital employed metrics, and less on growth through acquisition. Specifically, in international equities, we favour consumer brands, mission-critical software services and quality-assured health care companies.

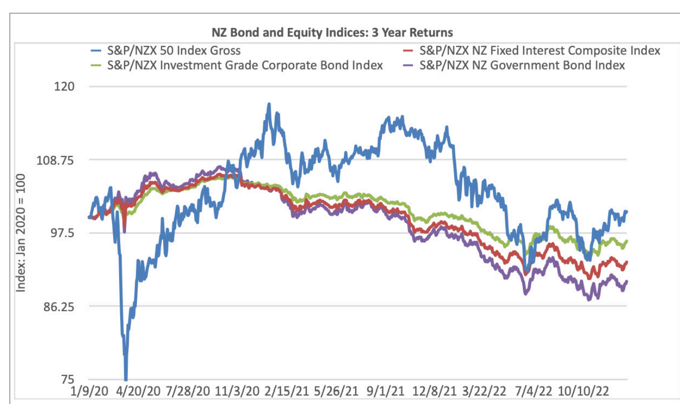
In domestic equities, as is discussed in detail in that section of this report, stocks that may be characterised as either secular growth or deep non-cyclical value may outperform in 2023. We feel, though, that the domestic equity market may struggle to exceed returns from global equities this year, due in part to the degree of monetary hawkishness evident from the Reserve Bank of New Zealand recently, and to the more exposed discretionary spending and property-wealth aspects of the typical NZ consumer to a phase of higher borrowing interest rates.

Range-trading bonds more probable than any sharp rally

In our "Global Outlook" report last quarter, we commented that bond yields had likely peaked and that a moderate rally was possible if inflation pressure continued to appear to be lessening across the board. This has proved to be the case, and the lower yields on longer-dated bonds that have emerged have triggered recent gains in the value of global property and infrastructure securities after a difficult 2022.

Upside risk to domestic bond yields can persist, until such a time as either broad consumer prices or labour markets definitively enter multi-month softening periods. That is not yet the case; however, as bond and equity markets are forward-looking it may become more evident by mid-2023.

In NZ, Equity returns still exceed Bonds' since Covid broke out



Source: S&P Global Indices

What we expect to see in 2023 is more differentiation between returns from different credit qualities, as borrowers are strained by low- or nil-growth economies and persisting higher costs.

Thus, we are willing to increase our allocations to the Fixed Interest asset class, but with an important caveat. We require our bond holdings to be differentiated by issuer objectives, structures and sustainability-linked outcomes, instead of scaling holdings by the size of an entity's rolling deficit or re-financing obligations.

We will expand on our thinking on the Fixed Interest sector's modified and future-focused role in well-constructed portfolios built to suit the conditions of the next few years, in an upcoming Salt Insights publication and in our next monthly Strategy Compass webinar.

Strategy conclusions

We retain our central market views for early-2023, reprised below:

- Equities (as a whole) will potentially see average annual returns close to their long-term norms in the next 3 years with interim weaker periods; selected Equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks that have lagged in recent years.
- For instance, listed real assets have superior, defensible yields and cyclical tailwinds, in a fraught political phase. Real Asset's historical sensitivity to rising bond yields may be counterbalanced by their cashflow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit. Bond yields have adjusted well, and may now plateau, which is positive for Real Estate.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown
- De-rating in very overvalued equities (specific companies, rather than sectors) is now advanced after interest rates moved up substantially. We do not anticipate a resumed bubble.
- Expect more M&A based on strong USD "war-chests" and also some abandoned corporate courtships as conditions shift and distressed firms multiply.
- After the severe global bond sell-off, we now see a better compensation for duration risk. Within fixed income, thematic support is ready to be a prime differentiator. We acknowledge sustainable or "green" bonds as a valuable emerging theme.
- Default risk and Credit Quality are likely to become a market focus later in 2023-4 and set off portfolio re-allocations within and beyond bonds.

This will set the stage for a global slowdown throughout 2023 as the lagged impacts of tightening of policy around the world continues to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities. Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, capital spending and productivity-led phase of economic growth.

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