FOURTH QUARTER 2022 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 January 2023

PORTFOLIO THEMES

- We believe a new bull market cycle is close, if not already underway. We expect the equities that fell the most during the downturn likely lead in the recovery.
- Widespread pessimism over inflation, central banks and recession likely creates an environment that supports positive returns in 2023.
- Underappreciated economic fundamentals such as strong loan growth, robust corporate balance sheets and continued strength in labour markets are largely incongruous with recession fears.

MARKET OUTLOOK

- **Global Market Recovery is Near or Underway:** Global equities' Q4 rebound demonstrates how a better than expected reality can quickly reverse market drawdowns. This also creates a path for material upside where growth likely proves more resilient and enduring than the current, dour forecasts expect.
- **Overly Depressed Investor Sentiment Supports Coming Rebound:** Universally dour sentiment, driven by concerns on inflation, energy crunches, the Russia-Ukraine War and a variety of other factors has significantly lowered investor expectations, allowing room for the new bull market to grow.
- **US Politics Provides Clear Path Forward for Markets:** Divided US government historically fuels a positive three-quarter stretch for equities—the three quarters starting 1 October in a midterm year were positive 92% of the time, with average returns of 20%. Similarly, the third year of a US president's term historically has the highest frequency of positive returns of the four-year cycle.

Q4 brought some relief from 2022's downturn with a 9.8% return for the MSCI ACWI Index—extending the long history of post-US midterm positivity.[i] Emerging Markets (EM) also rebounded and finished the quarter with a 9.7% gain.[ii] Turning points are impossible to predict and clear only in hindsight, and thus it is still too soon to know if October's low marked the bear market's end. However, whether the new bull market began in Q4 or arrives this year, we think equities are most likely to end 2023 higher.

In 2022, we expected early volatility with a late year rally, but the tragic Russia-Ukraine war, high inflation, interest rate hikes, political rancor and more dragged equities down into a shallow bear market. Usually, equities move past such widely known factors quickly. However, last year's constant stream of negative headlines, created yearlong uncertainty. Even when reality turned out better than feared—like second-half economic data—pessimists dismissed it, warning worse was still ahead, a classic sign of "the pessimism of disbelief" as we have often noted.

i Source: FactSet, as of 03/01/2023. MSCI ACWI Index return with net dividends, 01/10/2022 – 30/12/2022.

ii Source: FactSet, as of 03/01/2023. MSCI EM Index return with net dividends, 101/10/2022 – 30/12/2022.

Nevertheless, markets now appear to have reckoned with many of these concerns, and improvement on some—like inflation—should make 2023 a year of positive surprise, relief and recovery. In fact, we think the new bull market should bring sizable early gains where average S&P 500 returns in the 6 and 12 months off bear market lows since 1925 are 29.0% and 48.7%, respectively.[iii]

Positioning portfolios for a new bull market in 2023 is paramount now, even given the possibility of the long-feared recession. Surveys show business leaders, economists and almost everyone else expect an economic downturn, making this perhaps the most widely and longest-anticipated recession in US market history.[iv] That has given businesses time to prepare—and markets time to weigh the impact, muting the effects if recession arrives. As Ken has said, "anticipation is mitigation." Equities look forward, pre-pricing downturns. That may have been happening in 2022. If we don't get a severe 2023 recession, positive surprise would gradually replace fear as pessimists surrender, buoying equities.

Even if a recession occurs, it would be extraordinary for equities to decline from January 2022 to January 2024. Counterintuitively, a recession could grant clarity—ending the pessimistic cycle of waiting on negatives. To get a second down year would likely require something new and completely unexpected—not just a recession. While a true "black swan" event is possible, positioning for remote possibilities is unwise. Additionally, many say we need "capitulation" first. But that doesn't always happen and many factors, including weakness in most "safe haven" assets, suggest it won't now.

The overwhelming probability is the world looks much better at 2023's end than almost anyone perceives today. US politics is one reason. As we expected, the Republicans didn't get a landslide victory in November's midterms. But they won enough to deliver gridlock, kicking off the "Midterm Miracle"—history's most positive nine-month stretch starting in midterm year Q4s. 2022's was an almost perfectly average midterm Q4 return. A year from now, the reality of partisan gridlock will likely have dawned on all, with few major bills likely to pass. Inflation should keep slowing and Fed rate hikes will likely have proven feckless, as banks' high deposit bases mute the fed-funds rate's impact on loan profitability and enable banks to lend enthusiastically at big profits. On all fronts, we believe 2023 should bring relief.

Across the globe, Europe looks to have weathered feared winter energy shortages better than almost anyone envisioned. In the UK, many worried mid-December severe weather conditions would pressure the National Grid. But the public was able to use energy as normal, and the National Grid didn't have to resort to its emergency contingency plan of restarting two coal-fired power stations.

Another looming concern amongst global investors in Q4 is the continued possibility of a recession in Europe. Q3 UK GDP contracted -0.3% q/q, with the Bank of England presuming a downturn is already underway.[v] We have seen similar forecasts for the eurozone. The consensus views suggest baseline expectations for Western Europe's economic growth are dour, so if a downturn occurs, it wouldn't have much surprise power, in our view. Rather, it would confirm what most already anticipate and may actually reduce uncertainty. If the UK or eurozone grow at even a tepid rate this year, that could surprise to the upside—potentially lifting markets.

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iii Source: FactSet, as of 30/12/2022. S&P 500 average price return in the first 6 and 12 months of bull markets, 01/06/1932 – 30-/12/2022.

iv Source: Federal Reserve Bank of Dallas, The Wall Street Journal, Bank of America, Bloomberg, Barron's, Federal Reserve, PwC, AICPA and The Conference Board, as of 29/12/2022.

v Source: FactSet. Quarterly change in UK Q3 GDP.

In EM, China is reopening which should boost growth across Asian countries in time. After easing some restrictions in November, officials ended the requirement for people with mild or asymptomatic cases to quarantine in centralised facilities. People who have close contact with those who test positive may also quarantine at home from now on, and testing requirements for domestic travel have ended. While the government declined to downgrade the virus from a Category A to Category B infectious disease, which would have ended local authorities' ability to implement lockdowns, the overall acceleration of the end of Zero-COVID was seemingly enough to help investors price in the end of restrictions within the foreseeable future.

In the Latin American political landscape, Brazilian President Luiz Inácio "Lula" da Silva won the second round of October's presidential election against incumbent former President Jair Bolsonaro. However, right-leaning parties gained ground in October's election, which would give President Lula's allies less power when the new legislature convenes in February. Despite the rioting that has persisted well past the election, we think gridlock under the new administration will be stronger than many seem to anticipate today.

Peru also experienced a jolt from political uncertainty. Early in December, now-former President Pedro Castillo attempted to suspend the legislature, rule by decree, reorganise the judiciary and impose a nationwide curfew—a move widely condemned as an attempted coup. Congress impeached him in response, with the move earning broad support—even within former President Castillo's leftist party. The measure to remove him passed easily and Vice President Dina Boluarte assumed the presidency. While the political uncertainty for both countries remains tense and unclear for now, the potential for falling uncertainty in 2023 appears high.

On the sentiment front, US consumer confidence surveys hover near historical lows, yet consumer spending—adjusted for inflation—rose throughout the year. Bank executives talk up recession but aren't provisioning extra for loan losses. On the contrary, banks are lending freely despite the inverted yield curve. Traditionally, the inverted curve signaled recession because it meant banks' funding costs exceeded potential loan revenues, drying up credit. However, with deposits costing near-zero and loan interest rates up with long-term Treasury yields, lending has become even more profitable—hence, the fast loan growth. People rarely sit on borrowed money. They typically spend and invest it, fueling growth.

An abnormal 2022 feature was equities and bonds moving in parallel. That should continue in 2023—but positively this time—as it did in Q4 2022. US 10-year Treasury yields are already down nicely from recent highs, helped by easing inflation. Commodity prices are down, supply chains are evening out and money supply growth globally has cooled dramatically. In the US, it has flatlined. With this, the dollar should continue weakening from its relative high, easing false fears of it hampering multinational equities.

By yearend 2023, a new bull market cycle should be well underway, but the path won't be placid. Volatility and pullbacks have struck early in bull markets without derailing them. At this stage in the market cycle, patience is best and should be rewarded over time. Our priority is to best position portfolios to capture returns from the upcoming, or ongoing, recovery while many still can't fathom a positive 2023.

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