JAN 27, 2023

ECONOMIC ANALYSIS REPORT

BLACKELM EQUITY

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INFLATION, RATES, AND ECONOMY

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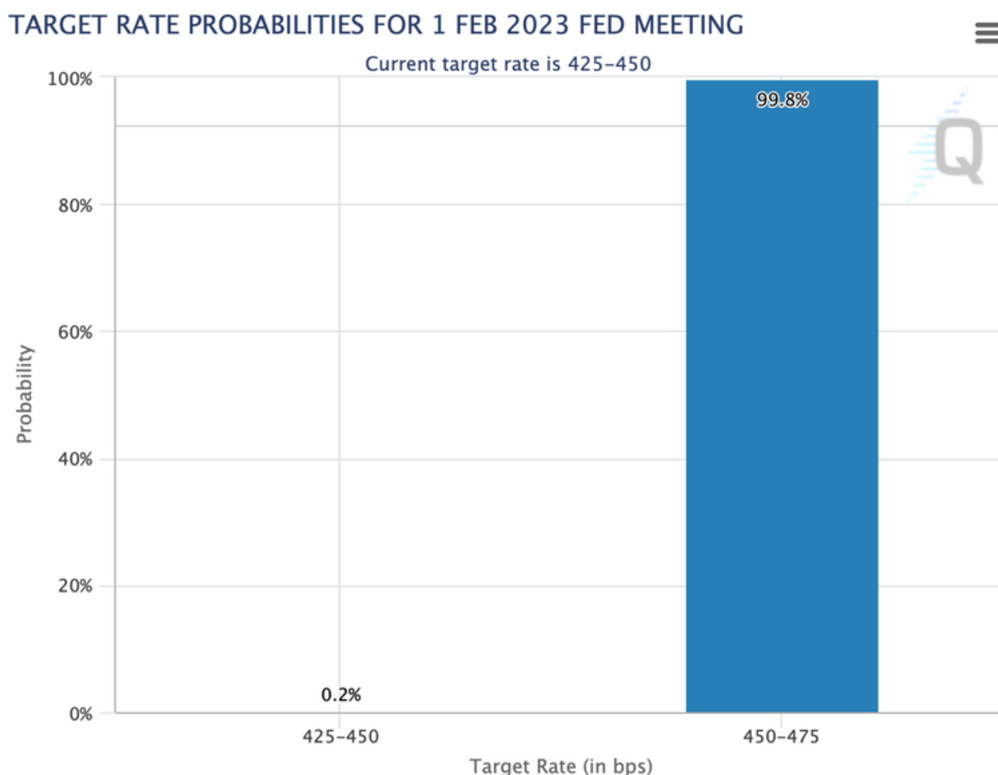
United States

Inflation in the United States is at its lowest level in more than a year, with the CPI standing at 6.5% as of December 2022. Inflation is still far from target, but cooling prices point to the effectiveness of the FED's intervention. Importantly, the one-year US inflation swap, a derivatives contract that reflects inflation expectations a year from now, stands at 1.77%, its lowest level in more than two years. Another market measure, the so-called one-year break-even inflation rate, currently stands at 2%. This suggests that inflation expectations are coming down, making the path toward 2% easier for the FED.

Inflation rate USA

INFLATION, RATES, AND ECONOMY

Interest rates in the US continue to rise, but at a slower pace. The most recent rate increase was of 50 basis points. Markets have priced in that the next rise, due February 1st, will be to the tune of 25 points, leaving the policy rate in a range of 4.50 – 4.75%. This is consistent with the rhetoric employed by members of the FED as of recent, characterized by a tone of cautious moderation. Inflation is in fact trending downwards, and as long as the CPI keeps falling, we expect the peak of interest rates to be on the horizon.



INFLATION, RATES, AND ECONOMY

There is ongoing debate about where interest rates will peak and how long they will stay at that level. FED officials have endorsed raising the benchmark federal funds rate above 5% and maintaining that level until at least the end of the year, in order to effectively stamp out inflation. The debate is intrinsically tied to the stickiness of prices, and we expect interest rates to follow the CPI print very closely. Jay Powell has demonstrated his adherence to data in the past, and it would be a gamble to bet that he will change this stance now. This leads us to the other ongoing debate about interest rates, how long will they stay elevated? There is a discord between the FED and the market consensus. The FED has repeatedly stated that they will stay the course on interest rates until the 2% inflation target is reached. The market, however, believes the FED will waiver, with futures markets pricing in that the central bank will succumb to pressure, cap its policy rate between 4.75 and 5%, and start cutting the benchmark rate before year end. History tells us that a half-baked policy response can cause more harm than good, with inflation bouncing back quickly and launching the economy back to square one. Investors would be wise to remain attentive to the FED's stance, as this will be a determining factor in how long we live with inflation.

The FED is determined that it can achieve a 'soft landing', i.e. taming inflation without tipping the economy into recession. The latest GDP data shows the US economy is slowing down but still growing (from 3.2% to 2.9%). These growth figures give credence to the 'soft landing' idea.

INFLATION, RATES, AND ECONOMY

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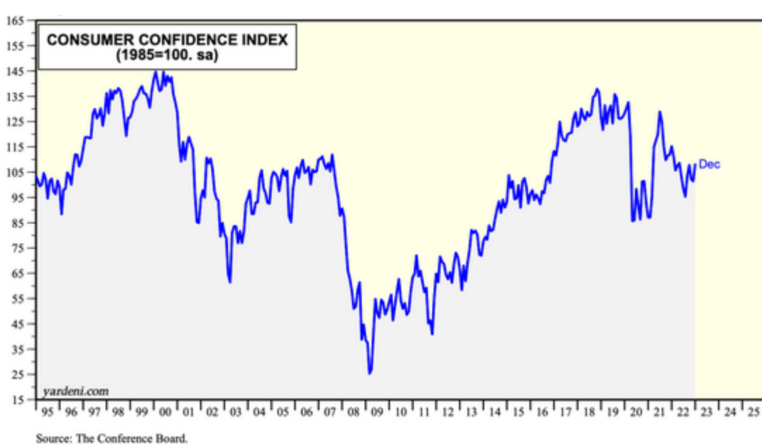
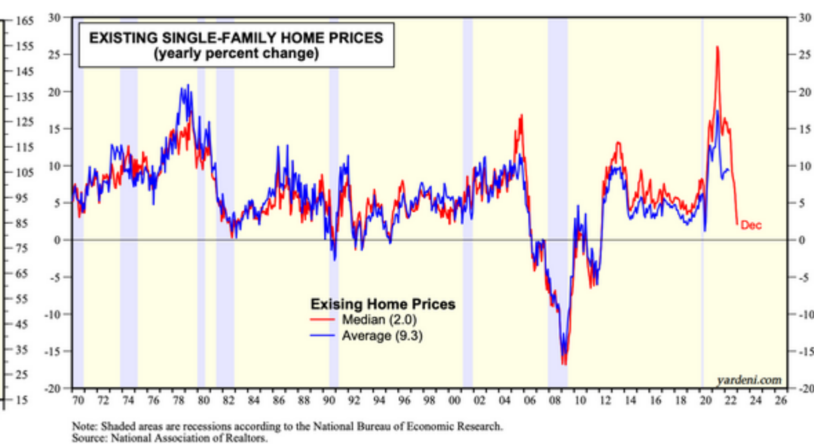
The US economy is responding to increasing interest rates. Consumer spending continues to slow, and demand for housing and cars (the purchases most sensitive to interest rates) are experiencing significant downward pressure. Although the unemployment rate remains at a historic low of 3.5%, job growth is cooling, however slightly, and big waves of layoffs are becoming the standard. Big tech has dominated the headlines with regards to cutbacks. Microsoft, Amazon, Alphabet and Twitter have all committed to laying off at least 10,000 employees each, in some cases the number is closer to 20,000. The damage extends beyond the tech sector, with white collar finance being especially targeted, as Goldman Sachs, Credit Suissee and Morgan Stanley announce layoffs of up to 6.5% of their workforces.This reflects how liquidity in the US is drying up, with deal making efforts choked by raising rates. In 2022, there were 85% fewer IPOs in the US compared to 2021. 2023 is also likely to dissuade IPOs, a venture which usually thrives with hot money.





INFLATION, RATES, AND ECONOMY

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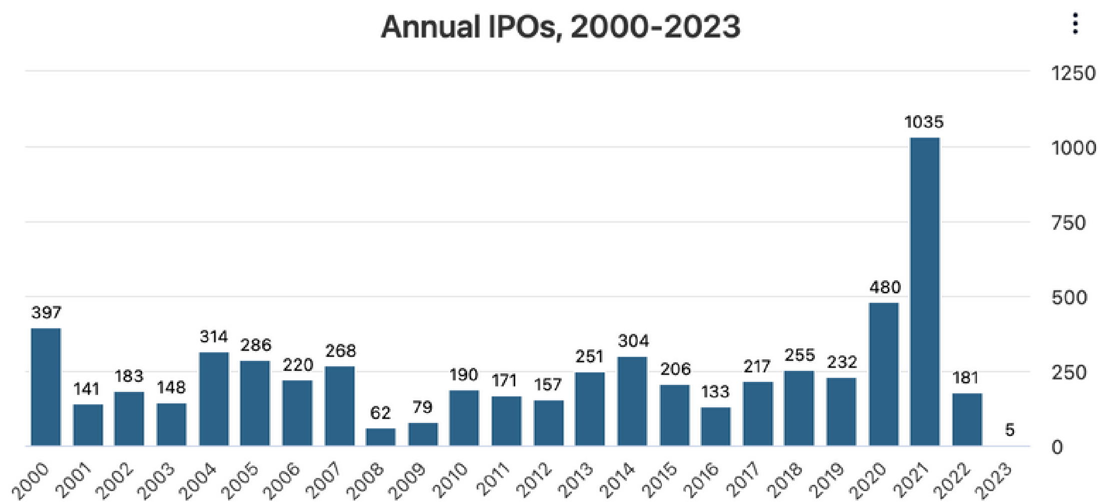

Source: Stock Analysis

UK and EU

The BoE's policy rate remains unchanged at 3.5%. The central bank is likely to continue its rate rises at the same pace, given inflation is far from the 2% target, currently at 10.5%. Economic growth remains sluggish, largely due to high prices squeezing consumer budgets. Energy bills remain a concern and continue to be one of the main challenges facing the UK. However, ebbing gas prices are likely to aid the BoE in their fight against inflation.

INFLATION, RATES, AND ECONOMY

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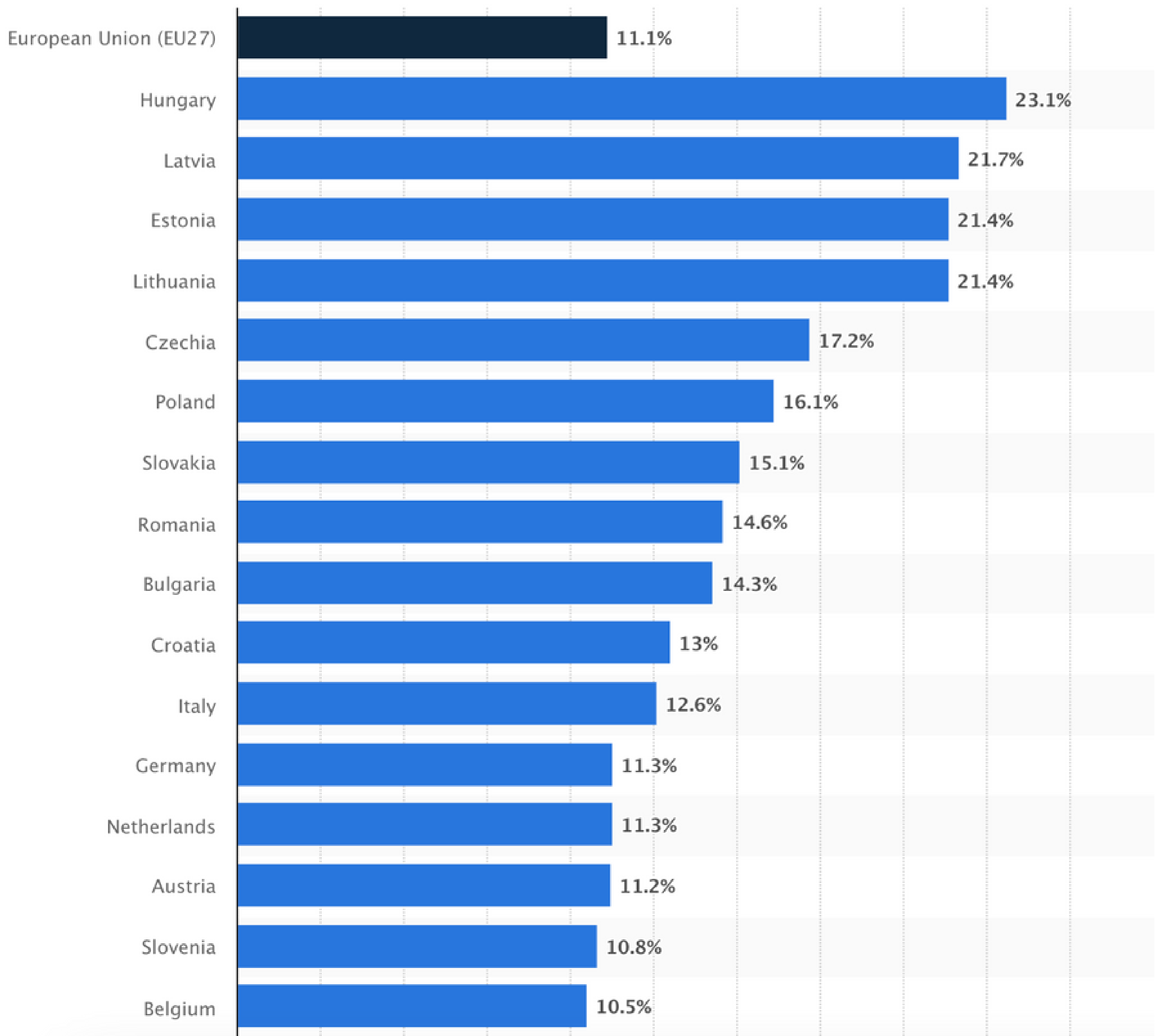
The UK remains one of the economies in the European area with the weakest post-pandemic recovery. With a wave of political turbulence and threats of national strikes, the economy lacks the flexibility and responsiveness to come out of the coming recession with speed. It is likely to lag behind the US both in interest rate response and economic recovery, a characteristic that it shares with many of its European neighbours.

Inflation in the eurozone remains higher than in the US, with many countries still in the double digits. As such, we expect interest rates to peak after the top in the US. The Eurozone is taking interest rate increases seriously, with central bankers pledging to stay the course on monetary tightening. A consensus that energy prices have peaked, along with increased gas reserves in Europe, has slightly lifted the economic outlook for 2023, with some economists saying the union will be able to technically avoid a recession. Putting this technicality aside, the Eurozone will experience slow growth in 2023, as prompted by its central bank. Stronger labour protection in Europe and a history of weak recoveries point to the lack of allocative efficiency in European labour markets. Although the consensus certainly suggests a shallower recession than that of the early 2010’s, a slow recovery looks likely for the monetary union.

INFLATION, RATES, AND ECONOMY



Double digit inflation rates in the EU (source: Statista)

INFLATION, RATES, AND ECONOMY

Global

We accept the consensus that many countries will undergo a recession in 2023, albeit a shallow one. The effects are distributed unevenly across the globe. Countries sensitive to oil prices (such as those of the EU block) have growth prospects tied to the evolving war in Ukraine. Moreover, emerging markets with heavily dollarised debt obligations are continuing to experience pressure from a strong dollar and rising interest rates. That being said, falling energy prices and China coming out of lockdown offer some relief to the global outlook. Supply chain bottlenecks which have played a significant role in elevated prices over the past 2 years are finally starting to loosen up. Moreover, Chinese markets becoming accessible again is a bullish signal for global growth. On the flip side, we expect Chinese demand for oil and energy to increase toward pre-pandemic levels, putting upward pressure on energy prices. This highlights how there are many push and pull forces acting upon the global growth outlook, and investors should be wary of looking for opportunities in emerging markets outside of fixed income–as of now the risk looks to be higher than the reward.

INFLATION, RATES, AND ECONOMY

Investors should remain attentive to inflation data and ignore market beliefs that the battle over inflation is won. The reality is the central banks must stay the course to stamp out inflation expectations, which are falling in the US and EU but remain suspiciously high in countries like the UK. Lastly, we want to point out the speed at which American businesses are shedding workers in light of the economic conditions. This highlights an impressive characteristic of the US economy: its flexibility. That the US was the first country to start laying off waves of workers is a strong signal that it will be the first to start hiring again. In a cynical fashion, layoffs are good news for investors, as this will put floors on the fall in big company earnings. The same cannot be said about businesses in the much more ‘firing frugal’ EU.

United States

The US equities ended the year on a mixed note, with the S&P 500 completing 2022 with a loss but a modest gain in December. Despite headwinds from a hawkish Federal Reserve, some sectors boasted positive returns.

The technology sector suffered in 2022, even if it has been a major driver of growth in the past. Rising oil prices and demand recovery led to a strong energy sector rebound. Healthcare was an investing safe heaven and managed to perform well.

US equities in 2023 are a challenging field. With uneven recovery expected due to rising inflation and interest rates, consumer spending and business investment will be affected. Market sentiment will mostly be piloted by monetary policy, but valuations seem to be at relative attractive levels, offering compelling opportunities. In conclusion, the US equity market may have opportunities for investors with long-term perspectives.

Europe

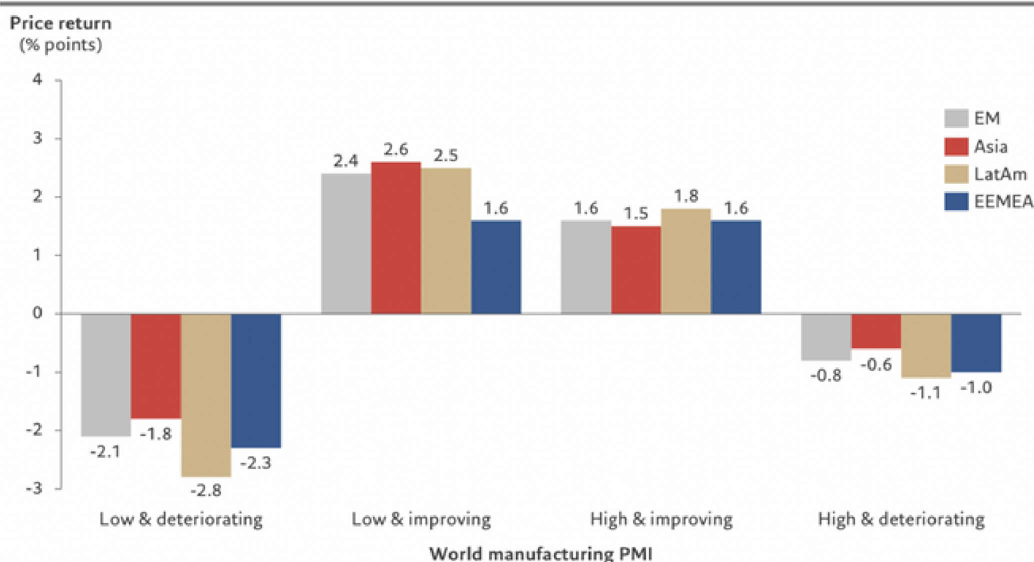
European Equities suffered from a turbulent 2022, and fears of inflation and potentially tighter monetary policy make for a bleak 2023. The European Central Bank raised interest rates by 0.5%, and further rate hikes might be on the way. GDP contracted by 0.3% in Q3, and all sectors but Healthcare ended the year at a loss. Telecoms and technology, much like in other geopolitical entities, performed the worst. The large-cap outperformed the small or mid-cap, while value stocks were a better option instead of growth stocks. While current conditions could offer themselves for attractive long-term returns if one focuses on resilient stocks with quality characteristics, investors should be wary of the geopolitical tensions the area faces.

Japan

Inflation, monetary tightening and recessionary fears damaged prospects of Japanese equities. Even if the market witnessed a rebound in November, economic data remained weak. Telecoms and tech led the December dive, to be survived by healthcare. Value stocks performed worse than growth stocks and the large cap was not as profitable as smaller options. Outlook for Japan is difficult to calculate, but unpredictable demand, coupled with supply chain issues cause volatility that is and will be reflected on earnings. However, opportunities lie in long-term quality investments, especially those which are expected to be resilient through recessions.

Emerging Markets

Emerging Markets suffered in December after a rebound in November, but outperformed most developed markets. The rising rates and a strong dollar is constantly putting downwards pressure on EM equities. Regionally, emerging Asia was the best performer, followed by emerging Europe, Middle East, and Africa (EMEA) and Latin America, though all regions ended in negative territory. India suffered from a currency depreciation. Risks in EMs seem to be priced in and many EMs have offered opportunities in previous crises for attractive long-term returns. We could see a similar outcome, but investors must be wary of inflation, geopolitical tensions and slowing growth.



EQUITIES

United Kingdom

In the United Kingdom, equities closed December on red, finishing 2022 at an appropriate tone. High inflation, tight monetary policy and signals of further rate hikes led to investors with a bearish outlook. Property prices fell for four consecutive months and economic data seems weak, with GDP contracting 0.3% at Q3. Similarly to other areas, healthcare was the only sector which did not end the month lower, while telecommunications and technology suffered. Resilience in equity portfolios must be a prime objective as the following year will weigh heavily on stocks.

Asia (ex Japan)

Asian Equities remained resilient in December, despite pandemic and other struggles. China and Hong Kong outperformed other asian markets, boosted by regulation and changing government policy. China seems more growth-friendly over 2023, and an accelerated recovery is a realistic prospect with COVID-0 policies being withdrawn. China's reopening should not be ignored by investors. Taiwan and South Korea declined sharply. Investors interested in Asian Equities should focus on recessionary resilience and various opportunities in select areas with particularly high selling pressure. Investors must remain aware that valuations may fluctuate and outlook still remains uncertain.

Case Study: Regulation in China

The financial markets regulator of China has started blocking national companies belonging to certain industries from listing on stock exchanges. That is part of an effort to channel funding into some specific strategic industries. "Red light" status industries include food, beverage and COVID-19 testing. These are off-limits to equity financing in stock exchanges from Shanghai to Shenzhen. "Yellow light" industries, such as apparel and furniture will come under heavy scrutiny for their public offerings, especially if they are heavily reliant on debt for growth.

The China Securities Regulatory Commission (CSRC) is acting in accordance to Beijing's efforts to steer the country's financial exchanges towards serving the national agenda. As China is working towards technological self-reliance and economic growth, investors will be heavily incentivised to invest in such opportunities in the future.

EQUITIES

The newly enforced regulation could have an impact on Chinese-listed IPOs, as “red-lighted” industries will be unable to tap into equity financing and “yellow-light” industries will face greater scrutiny and bureaucratic difficulties. This could lead to a slowdown in the number of listings, a shift towards alternate financing and an overvaluing of industries with a “green-light”.

Of interest to investors should be that these measures could crowd out foreign interest to Chinese capital markets and could negatively influence China’s strategic goal of becoming a leading force of the financial world. Companies in specific industries will find it hard to access capital, reducing their potential. It is paramount that investors monitor how these regulations affect the capital markets and specific industries, as opportunities are expected to rise.

Oil, Mining , and Semiconductors

2022 has been a hectic year for the price of energy and many commodities. Together with below target supply from OPEC, increased tension over the Ukraine crisis helped to push oil prices to a peak of more than $120 a barrel last summer. However, we believe that the recent reopening of the Chinese economy will stabilize commodity demand in 2023. This is good news for an international economy that is very sensitive to energy prices, as proven by the economic conditions experienced in Europe during 2022. Global oil demand is predicted to grow by 1.9mn barrels per day in 2023.

BHP, the world's largest mining company, is convinced that China's stimulus for the property sector will assist "progressive improvement from the difficult economic conditions of the first half". In order with Xi Jinping's agenda to end its international isolation, China also relaxed an unofficial ban on imports of Australian coal that was helping to drive prices of the commodity to six-month highs. Australia's first coal shipments to China in two years are expected to arrive next month. Consequently, everything points to China will once again start acting like a stabilising force when it comes to commodity demand in the 2023.

The semiconductor Industry is facing a similar situation. Demand for chips fell last year due to inflation, recession concerns and China's Covid restrictions. Highly profitable companies such as Samsung were hit by their first profit fall in three years as global chip demand slowed down. As part of the US agenda to prevent European companies from supplying necessary materials for chip production to China, Japan and the Netherlands are interning negotiation to potentially tighten restrictions on exports. However, we doubt these trading disputes are enough to deter the Chinese economy from resurging as a big semiconductor importer. In that way, Europe's biggest semiconductor (ASML) said they expects demand for semiconductors to recover in the second half of the year. Being the only company in the world capable of producing complex extreme lithography, ASML plays a crucial role in the semiconductor industry. Most chip producing companies such Taiwan Semiconductor Manufacturing Co, Intel and Samsung all rely on ASML's services. Despite Apple's commitment to controlling the production of its components, it will still rely on complex extreme lithography. In that way, signals of ASML picking up production in 2023 represent very good news for the semiconductor industry.

"We're going to get a lot more semiconductor capacity in the second half of 2022 – we're nearing the end of the supply crunch. However, capacity still needs to be qualified for use in the automotive industry. Can the right matching occur between available supply and correct qualification? This is the difficulty that remains."

Sandeep Deshpande, Head of European Technology Research, J.P. Morgan

Income is Back in Fixed Income

The post-pandemic recovery has proved challenging for fixed income investors. Multiverse index, a data provider, estimates that global government and corporate debt fell nearly 16% in market value terms, wiping out $9.6 trillion. In modern history, whilst one year of negative returns for bonds is rare, two in a row are unprecedented. Reflecting on the past year's largest surprise – the persistence of inflation –, we identify three key factors which are attributable to bonds' performance: a macroeconomic environment of rising interest rates, the depressed starting level of yields following QE liquidity and zero lower bound central bank policies, and the speed of repricing (with high mark-to-market volatility). Whereas the third factor remains arduous, the current level of yields (high in historical terms) and the near-term trajectory of interest rates should a recession materialise suggest a deeply attractive entry point in fixed income.

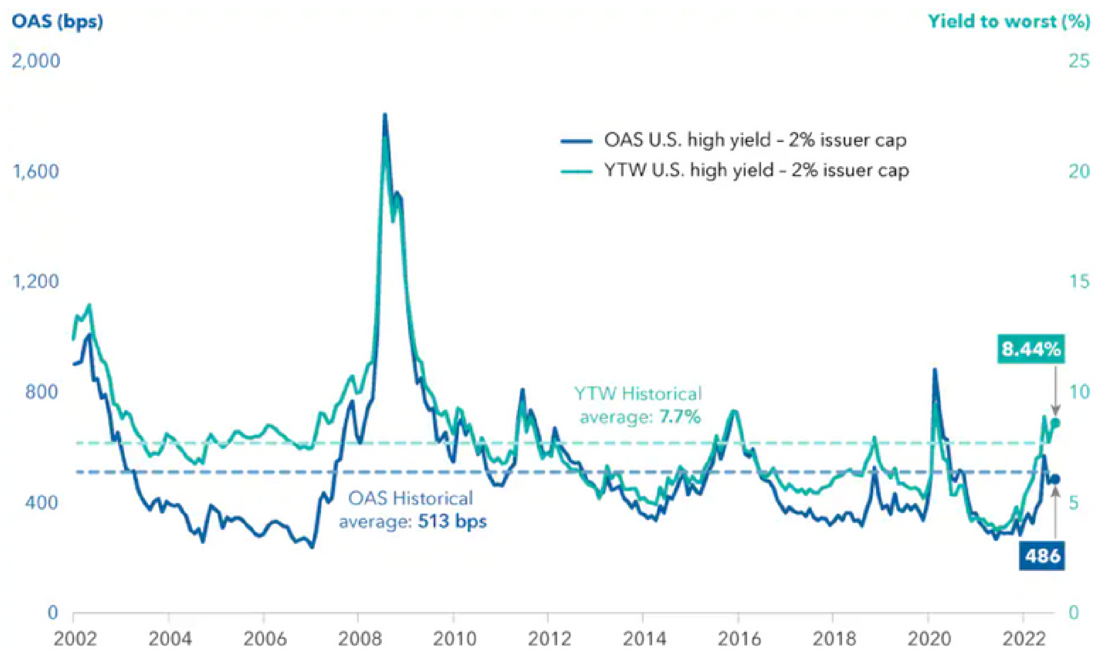
We believe investors should question their expectations from the bond side of their portfolios, rather than taking the traditional 60/40 for granted. First, bonds provide diversification benefits due to their traditional negative correlation with equities; we expect the negative association to return in 2023 after 2022's exceptional conditions. Further, market repricing implies the emergence of opportunities to benefit from the "yield cushion" (i. e., the relatively high levels of yield-to-maturity across the risk and term spectrum). This offers portfolio managers with two additional catalysts: consistent coupon income and the potential for capital appreciation in periods of declining interest rates.

This year, we expect the negative driving forces of 2022 will act in the opposite direction. First, the starting level of yields – a proxy for forward returns – are notably higher. In U. S. Treasuries, the world's most liquid bond market, 10-year yields jumped from 1.6% to 3.9% – the biggest spike since 1788. This has translated to higher interest rates across global bond markets, ranging from 5% in investment-grade bonds to over 9% in global high-yield corporates or emerging market debt. Beyond absolute measures, equity market's narrow risk premium and still-elevated forward P/E ratios, while more favourable than one year ago, indicate opportunities for bonds' relative outperformance.

In our evaluation of credit and duration risk, we favour high-quality companies and sovereigns (with ratings from AAA to BBB-) due to their implied negligible default risk. Notably, the yield on global investment grade corporates (~5%) is higher than the 3-4% on risky HY debt a year ago. This illustrates a generational event in investment management, in our view. For instance, Bloomberg's US Aggregate Credit Yield to Worst closed on 4.89% on January 26. Eurozone corporate credit, such as the S&P Investment Grade Corporate Bond Index, is also compelling: with an average maturity of 5.37 years, the current yield to worst of 3.74% is significantly above the index's historical average of under 2%. However, spread levels against risk-free rates remain subdued compared to prior recessions and could widen in the short-term, for which investors should expect further volatility.

Source: S&P Dow Jones Indices

In the high-yield market, there is light at the end of the tunnel. High-yield corporates have traditionally suffered in prior demand contractions, as a flight to safety in financial markets and declining profits led to rising spreads. Currently, high-yield spreads and yields are similar to long-term averages. Despite the widespread anticipation of greater default rates among the tightening of financial conditions, our team believes that DM high-yield businesses, especially in the US, are more resilient than in previous crises.



Source: Capital Group

This is due to three main factors. First, policy accommodation after Covid-19 gave most companies incentives to issue long-term debt during the pandemic, locking in low coupon rates, pushing maturities and limiting refinancing/rollover risk. Second, “fallen angels” (rated IG before the pandemic) have caused a much larger share (50%) of BB-rated debt in the US high-yield segment. As a result, the latest 12-month default rate of 1.2% is strongly below the historical average of 1.3%. Thirdly, from a flow-of-funds approach, households and corporates are running a larger financial surplus (income minus spending or, equivalently, savings minus investment) than prior to any other US recessions. The positive effects on private sector balance sheets, liquidity and capital buffers will counteract declining economic activity.

Geographically, DMs seem more attractive than Asia in our view, due to interest rate differentials amid different central bank tightening cycles and inflationary pressures. However, business cycle disparities and the reopening of China following the pivot from the ‘zero Covid’ policy point to demand and output growth in Asia, with an optimistic near-term outlook. The direct externalities on EMs, especially commodity exporters, provide compelling views of EM local currency sovereign and corporate debt, further supported by the very high terminal rates priced in. Yet, hard-currency (mostly USD-denominated) and HY credit has a high sensitivity to EM capital outflows, shifting variable rates and USD strength, for which we remain cautious.

House price and rental disinflation may turn into outright deflation in most advanced economies, given real estate's intrinsic interest rate-sensitive characteristics. We remain underweight on mortgage backed securities or other property-linked asset-backed despite attractive valuation, on the basis of supply (e.g., housing starts or construction permits) or demand-side (mortgage applications) leading indicators, recession risks and credit defaults. We are neutral on other securitised credit (based on credit card, student or auto debt), as wide spreads offer protection to deteriorating fundamentals.

Finally, in terms of duration, opportunities to exploit the inverted yield curve are attractive on a short-term capital allocation perspective, especially in higher-yielding segments like EMs or securitised products. Yet, for high-quality DM sovereign or corporate credit, longer-term yields are at levels not seen since before the Global Financial Crisis. We thus remain overweight on short and long duration, with a tactical preference for high-quality issuers.

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