SIGMA
PRIVATE OFFICE

Q4 2022 QUARTERLY REVIEW AND OUTLOOK

MARKET REVIEW & OUTLOOK

2022 was a year of surprises and proved to be the most challenging year for investors since the 2008 Global Financial Crisis. The post-COVID recovery, brought booming equity markets in 2020 and 2021 as the global economy experienced its strongest rebound in economic growth on record. At the turn of the year, expectations were for global growth to continue above trend, although normalise as the reopening tailwind slowed. However, 2022 ended up being the year of economic hangovers from COVID lockdowns and its unprecedented fiscal stimulus. Global supply chains were stretched to their limits, China maintained its zero-COVID policy, a major war in Europe sent oil, gas and food prices soaring and labour demand surged, creating a perfect storm for higher inflation. As such, the Federal Reserve was quickly forced to change their rhetoric around transitory inflation as they embarked on the fastest rate hiking cycle in history. Other central banks soon followed suit, fuelling the global sell-off.

The final quarter of 2022 rounded off the year with another volatile period for equity markets. The summertime rally, fuelled by early signs of inflation peaking, a China reopening and resilient S&P500 corporate earnings growth of 9.2% unfortunately gave way to new bear market lows in mid-October as the Federal Reserve stressed their higher for longer message. This coincided with the US 10 Year Treasury yield peaking at 4.25%. From there, similarly to what we witnessed in March and July, equity markets rebounded strongly, and bond yields retraced through to early December as inflation readings showed clear signs of cooling and mass protests in China ignited reopening optimism. However, equity markets ended the year on a slightly sour note, giving away some of their gains in the final weeks of December as light trading volumes exacerbated stock moves.

The MSCI World Index, a benchmark for global equities, ended the year down 17.73%, having breached the "Bear Market" threshold of -20% during 2022. The S&P 500 finished 2022 down 19.44%, the Euro STOXX 600 declined 12.90% whilst the FTSE 100 ended the year flat at 0.91%, predominantly due to a strong US Dollar helping in local currency terms. Unlike historic periods of stress, bonds failed to provide their typical protection in multi-asset portfolios with US Treasuries down 12.5% over the year, and global investment grade bonds down 16.7%, leaving few investors unscathed.

Value stocks finally had their moment, outperforming growth stocks in 2022, having lagged for most of the last decade. Value's strength was predominantly driven by the energy sector, which saw earnings growth of more than 130% last year as oil prices peaked above $120 per barrel in March. While we continue to believe growth stocks will outperform in the rebound and over the longer term, chart 1 illustrates the importance of maintaining a well-diversified portfolio as there is never one style leader and leadership changes often happen unexpectedly.

In currency markets, the majority of 2022 was defined by US Dollar strength as the Federal Reserve led the global rate hiking cycle. EUR/USD broke parity for the first time in two decades as the war in Ukraine, and the ensuing energy crisis, weighed on European sentiment. Likewise, GBP/USD fell to multi-decade lows on the back of an unimpressive "Growth Plan" from the short-lived Truss government. Sterling found some of its footing again, closing the year at 1.21 GBP/USD, following the appointment of Rishi Sunak as Prime Minister in October. The fourth quarter saw a broader reversal of dollar strength as equity markets rebounded, commodity prices fell and risk sentiment improved.

CHART 1
ASSET CLASS AND STYLE RETURNS

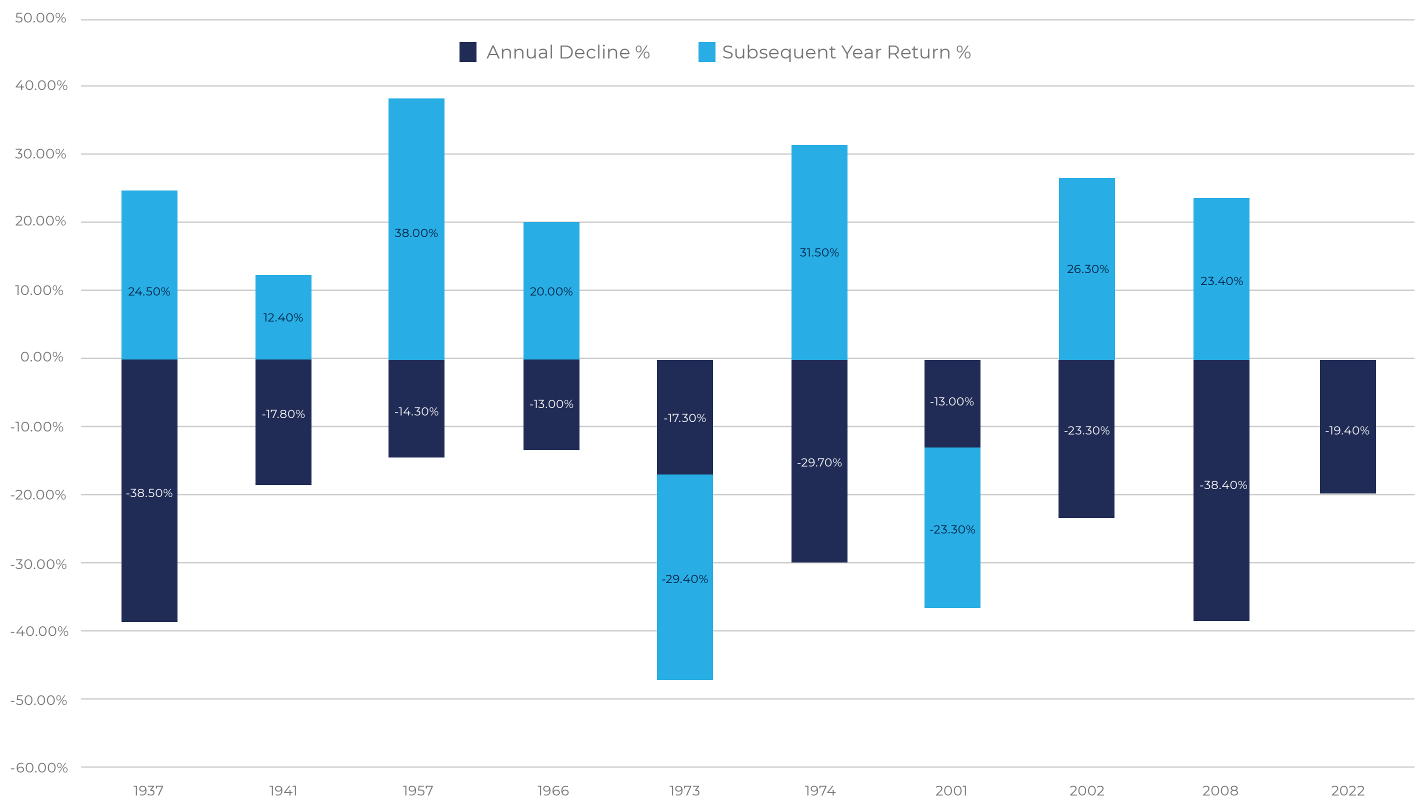
2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Q4 '22
SMALL CAP 26.6%	GLOBAL BONDS 5.6%	GLOBAL REITS 23%	SMALL CAP 32.9%	GLOBAL REITS 22.9%	GROWTH 3.5%	SMALL CAP 13.3%	EM EQUITIES 37.8%	GLOBAL BONDS -1.2%	GROWTH 34.1%	GROWTH 34.2%	GLOBAL REITS 32.6%	COMMODITY 16.1%	VALUE 14.9%
GLOBAL REITS 22.8%	GLOBAL REITS 2.3%	EM EQUITIES 18.6%	VALUE 27.5%	GROWTH 6.5%	GLOBAL REITS 0.6%	VALUE 13.2%	GROWTH 28.5%	GLOBAL REITS -4.9%	DM EQUITIES 28.4%	EM EQUITIES 18.7%	COMMODITY 27.1%	VALUE -5.8%	SMALL CAP 10.9%
EM EQUITIES 19.2%	VALUE -4.9%	SMALL CAP 18.1%	DM EQUITIES 27.4%	DM EQUITIES 5.5%	SMALL CAP 0.1%	COMMODITY 11.8%	SMALL CAP 23.2%	GROWTH -6.4%	SMALL CAP 26.8%	DM EQUITIES 16.5%	VALUE 22.8%	GLOBAL BONDS -16.2%	DM EQUITIES 9.9%
COMMODITY 16.8%	DM EQUITIES -5.0%	GROWTH 16.6%	GROWTH 27.2%	VALUE 4.4%	DM EQUITIES -0.3%	EM EQUITIES 11.6%	DM EQUITIES 23.1%	DM EQUITIES -8.2%	GLOBAL REITS 24.4%	SMALL CAP 16.5%	DM EQUITIES 22.3%	DM EQUITIES -17.7%	EM EQUITIES 9.8%
GROWTH 14.9%	GROWTH -5.1%	DM EQUITIES 16.5%	GLOBAL REITS 2.3%	SMALL CAP 2.3%	GLOBAL BONDS -3.2%	DM EQUITIES 8.2%	VALUE 18.0%	VALUE -10.1%	VALUE 22.7%	GLOBAL BONDS 9.2%	GROWTH 21.4%	SMALL CAP -18.4%	GLOBAL REITS 6.9%
DM EQUITIES 12.3%	SMALL CAP -8.7%	VALUE 16.4%	EM EQUITIES -2.3%	GLOBAL BONDS 0.6%	VALUE -4.1%	GLOBAL REITS 6.5%	GLOBAL REITS 8%	COMMODITY -11.2%	EM EQUITIES 18.9%	VALUE -0.4%	SMALL CAP 16.2%	EM EQUITIES -19.7%	GROWTH 4.8%
VALUE 9.8%	COMMODITY -13.3%	GLOBAL BONDS 4.3%	GLOBAL BONDS -2.6%	EM EQUITIES -1.8%	EM EQUITIES -14.6%	GROWTH 3.2%	GLOBAL BONDS 7.4%	SMALL CAP -13.5%	COMMODITY 7.7%	COMMODITY -3.1%	EM EQUITIES -2.2%	GLOBAL REITS -23.7%	GLOBAL BONDS 4.6%
GLOBAL BONDS 5.5%	EM EQUITIES -18.2%	COMMODITY -1.1%	COMMODITY -9.5%	COMMODITY -17%	COMMODITY -24.7%	GLOBAL BONDS 2.1%	COMMODITY 1.7%	EM EQUITIES -14.2%	GLOBAL BONDS 6.8%	GLOBAL REITS -10.4%	GLOBAL BONDS -4.7%	GROWTH -29.1%	COMMODITY 2.2%

Source: J.P. Morgan Asset Management, as of 31/12/2022. DM Equities: MSCI World, Global REITS: FTSE NAREIT, Commodity: Bloomberg Commodity Index, Global Bonds: Barclays Global Aggregate, Growth: MSCI World Growth, Value: MSCI World Value, Small Cap: MSCI World Small Cap. All indices are total return in US Dollars.

Investors' patience was tested throughout 2022. All asset classes experienced heightened volatility and bear market rallies turned to new bear market lows as sentiment collapsed. The biggest challenge for investors was keeping their composure and staying invested during a tumultuous year dominated by numerous negative headlines. While many investors unnecessarily change portfolio allocations during periods of market turbulence to avoid the regret of not doing something, history suggests timing markets in this way is notoriously difficult and costly to longer term returns. Rather, volatility is, and should be seen as, part of your investment journey. Volatility is the short-term risk investors take to achieve strong long-term returns and history shows that it won't stop you from reaching your goals if you can ride it out and participate in the rebound that follows.

Looking ahead to 2023, and despite the challenges that remain, there are reasons to be optimistic. Firstly, the global economy held up much better than feared and markets have already priced in a mild global recession as we discuss in our economic outlook below. Secondly, the forward-looking nature of markets also means it is likely we will see a rebound in stock markets before the economy bottoms out. Take 2009 as an example, equities bottomed on 9th March, more than 3 months before the recession ended in June, with the S&P 500 returning over 40% during the period. Finally, back-to-back down years for US equities are very rare. The last time it happened was 2000-02, while before that it was 1973-74, 1939-41 and the Great Depression years of 1929-1933. More commonly rather, bad years for financial markets are followed by very good years, as shown in chart 2. This leaves us of the view that investors now have a very attractive entry point to take advantage of and should benefit from compelling returns in the years to come.

CHART 2
S&P 500 SUBSEQUENT ANNUAL RETURNS FOLLOWING NEGATIVE YEARS



Source: Factset, S&P 500 Calendar Year Returns

ECONOMIC OUTLOOK

In this section we take stock of important economic indicators and what they mean for major global economies in 2023. Despite recent setbacks, the US economy has held up better than most developed world nations this past year and appears set to do so in 2023 as well. The US economy contracted in the first and second quarter of the year, but failed to meet the broad definition of a recession, before output rebounded strongly in Q3 (annualised rate of 3.2%). While a mild recession in the US in 2023 is possible, we think it is far from certain and a soft landing is not entirely off the cards. In contrast to the US, Europe and the UK are likely to go into recession in 2023, albeit mild, as higher inflation weighs on real incomes, consumption and industrial production.

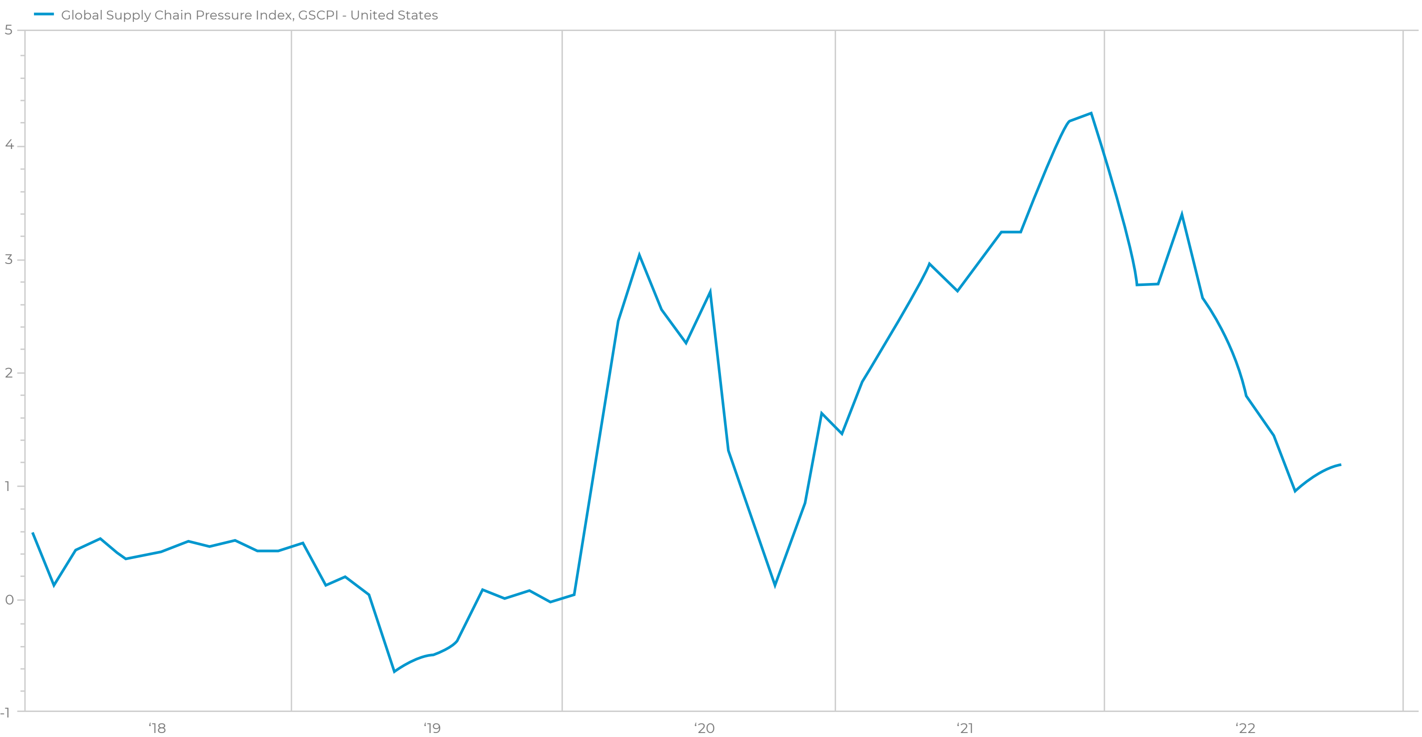
INFLATION

There is clear evidence now that the inflation tide in the US turned this summer after peaking at 9.1% y/y in June. The Consumer Price Index (CPI) readings in October and November came in lower than expected and fell to their lowest levels since December '21. Goods price inflation is falling rapidly as global supply chain pressures ease (chart 3) and input costs fall; shipping costs have collapsed over 70% from their peaks and industrial commodity prices are down more than 35%.

However, services prices remain stubbornly sticky (chart 4), reflecting tight labour markets and elevated housing related costs. We will touch on both these markets in more detail shortly, but it is important to note that a slowdown in both has a lagged effect on inflation readings, something the Federal Reserve is also cognisant of.

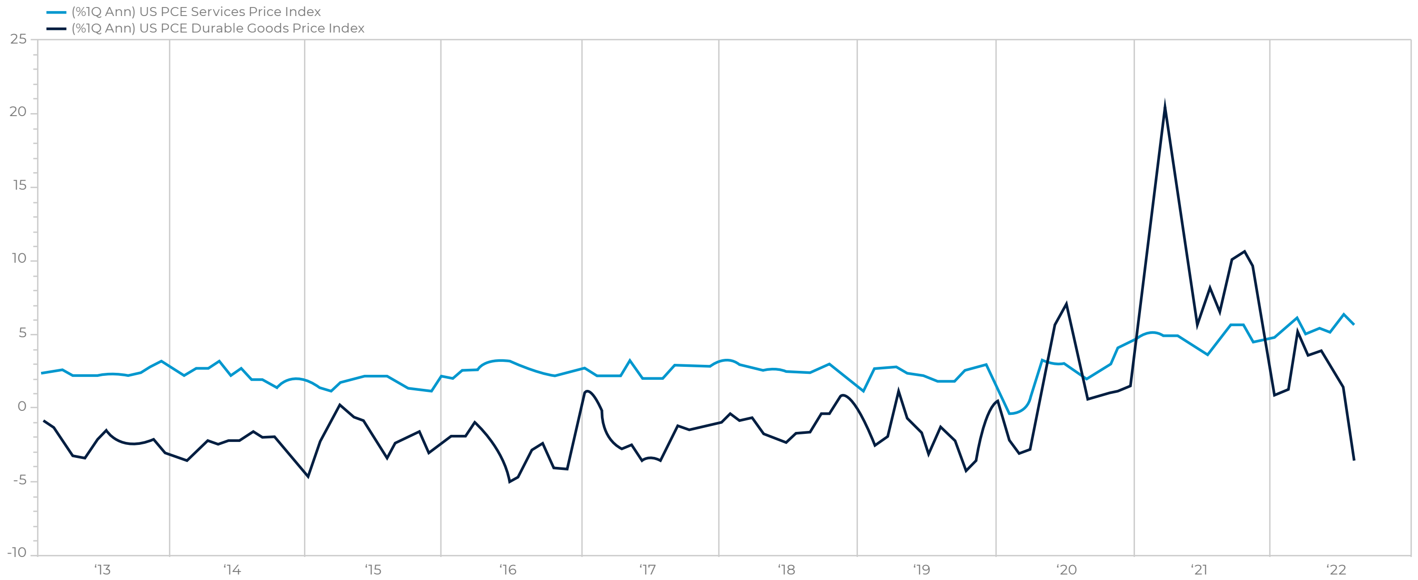
Over in Europe, there are preliminary signs inflation in the Euro Area may have peaked in October at 10.6% y/y, having come down to 10% y/y in November. Likewise, in the UK, November's 10.67% CPI reading was down from October. Unsurprisingly, energy has been the largest contributor given Europe's reliance on Russian oil and gas. While Europe was vulnerable to further supply-side troubles, policymakers managed to ramp up natural gas storage levels to circa 90% of total capacity much faster than feared. Furthermore, an increase in LNG (liquefied natural gas) imports is helping offset supply shortfalls and pricing pressures. Short of an abnormally cold winter, Europe should be over the worst of its energy troubles for now. Like the US, Europe and the UK will benefit from goods disinflation and as such, we expect global inflation to continue its downward trajectory throughout 2023, reaching levels more consistent with central banks targets by 2024.

CHART 3
GLOBAL SUPPLY CHAIN PRESSURES ARE EASING



Source: Factset, as of 31/12/2022, Global Supply Chain Pressure Index

CHART 4
GOODS PRICES FALL WHILE SERVICES PRICES REMAIN STICKY

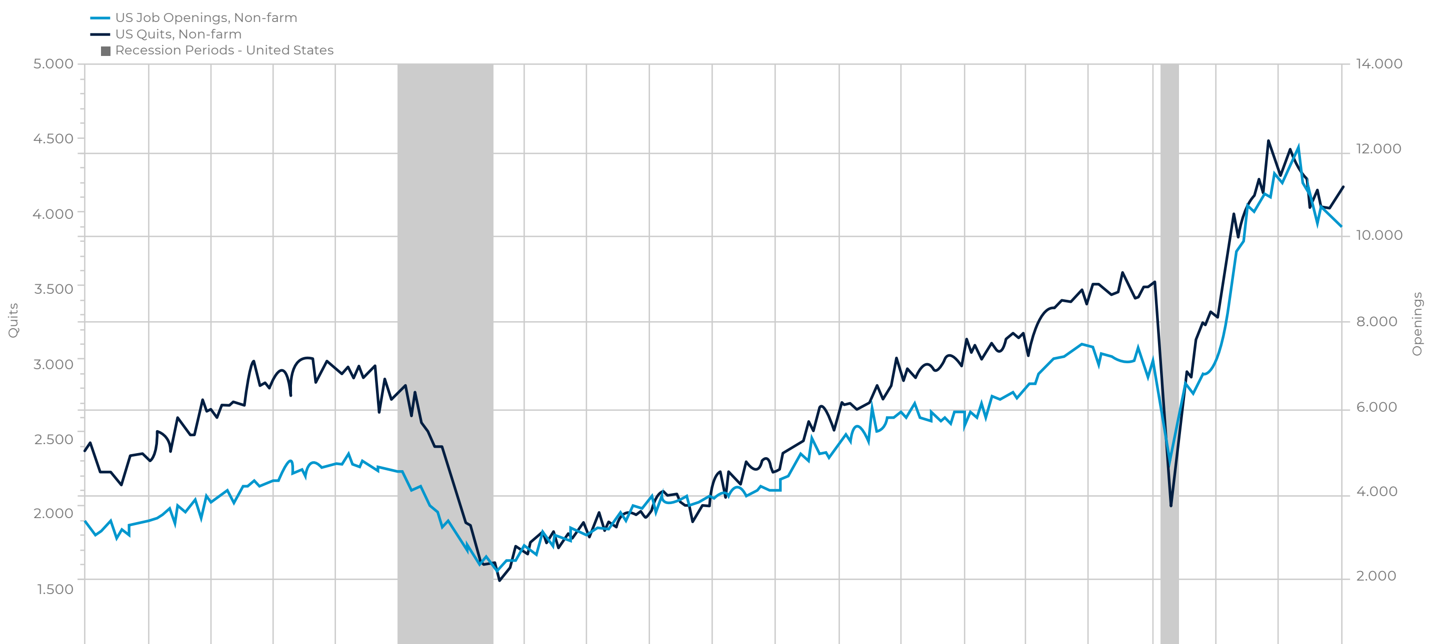


Source: Factset, as of 30/11/2022, Personal Consumption Expenditure Price Index (%1Q Ann)

THE LABOUR MARKET

Labour markets have remained markedly resilient so far. The unemployment rate in the US is close to multi-decade lows at 3.7% and job growth is steady. Likewise, the UK faces an overheated labour market while the European labour market has more slack with unemployment hovering around 6%. However, we are starting to see signs of a slowdown with demand for labour having peaked and the quits rate rolling over (chart 5). Corporates globally are increasingly reporting moderating labour demand and cost cutting suggesting the central banks are having their desired effect. A broad slowdown in the economy should help wage growth rollover, while allowing central banks to bring down inflation without materially increasing the unemployment rate.

CHART 5
LABOUR DEMAND HAS PEAKED



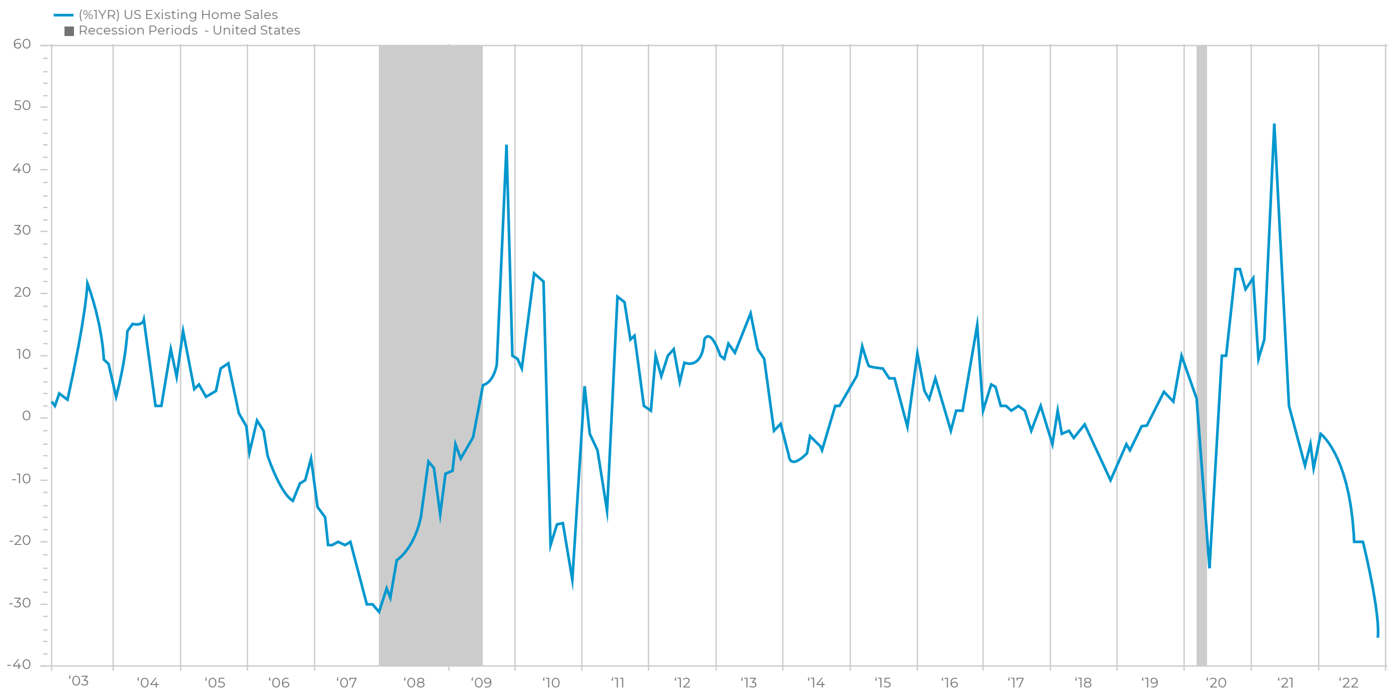
Source: Factset, as of 30/11/2022, US JOLTS Report, Non-farm Job Openings and Quits

THE HOUSING MARKET

The global housing market looks set to come under pressure in 2023 as higher mortgage rates and concerns over the economy rattle buyers and sellers. In the US, housing demand has fallen to levels last seen during the worst of the pandemic (chart 6) and house prices declined for four consecutive months. House prices are likely to continue coming under further pressure and the impact of this will feed through to the Owners' Equivalent Rent (OER) component of CPI next year, reinforcing the downward inflationary trajectory.

CHART 6

EXISTING HOME SALES SLUMP

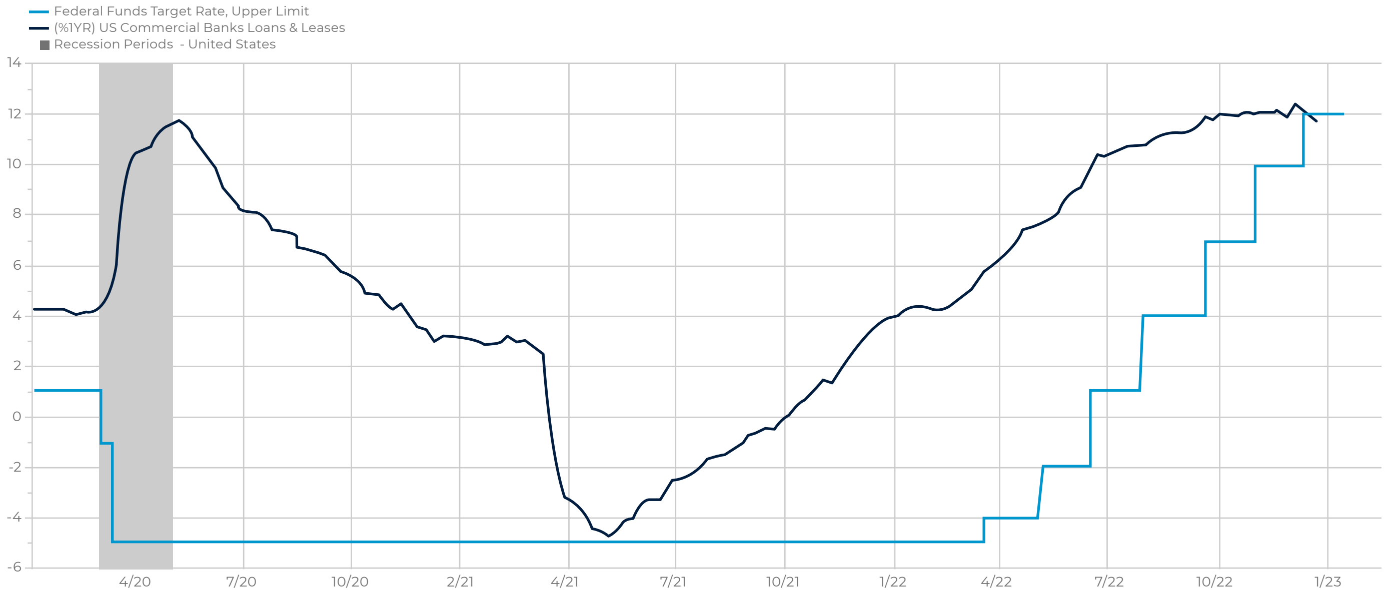


Source: Factset, as of 30/11/2022, US National Association of Realtors, Existing Home Sales

THE YIELD CURVE

The yield curve is one of the most reliable leading indicators out there as an inverted yield curve has preceded the vast majority of past recessions. Recently the most telling yield curve, the 3m10y, inverted and the spread fell as low as -0.8%, a level last seen in early 2001. While media headlines proclaim this is a sure-fire sign of a recession ahead, they ignore some of the nuances currently at play. Let's start by considering why the yield curve has its' predictive power. Banks borrow at short-term interest rates and lend at long rates, making the difference between the two, their net interest margin. The spread is therefore an indication of bank lending profitability; bank lending is the driving force of economic growth and the wider the spread the greater the incentive to lend. Normally, 3-month rates are a good approximation of banks' borrowing costs, but today, abundant cash deposits keep deposit rates far below current 3-month rates. The Federal Reserve estimates that total deposits are $6.3 trillion higher than the total amount of loans outstanding so banks don't need to raise rates to compete for deposits. As such bank lending today is far more profitable than the traditional yield curve spread would imply and largely explains why loan growth continues to run above 10% y/y, as shown in chart 7. The same applies to global loan growth which is fuel for investment and incongruent with an imminent recession.

CHART 7
LOAN GROWTH REMAINS HEALTHY

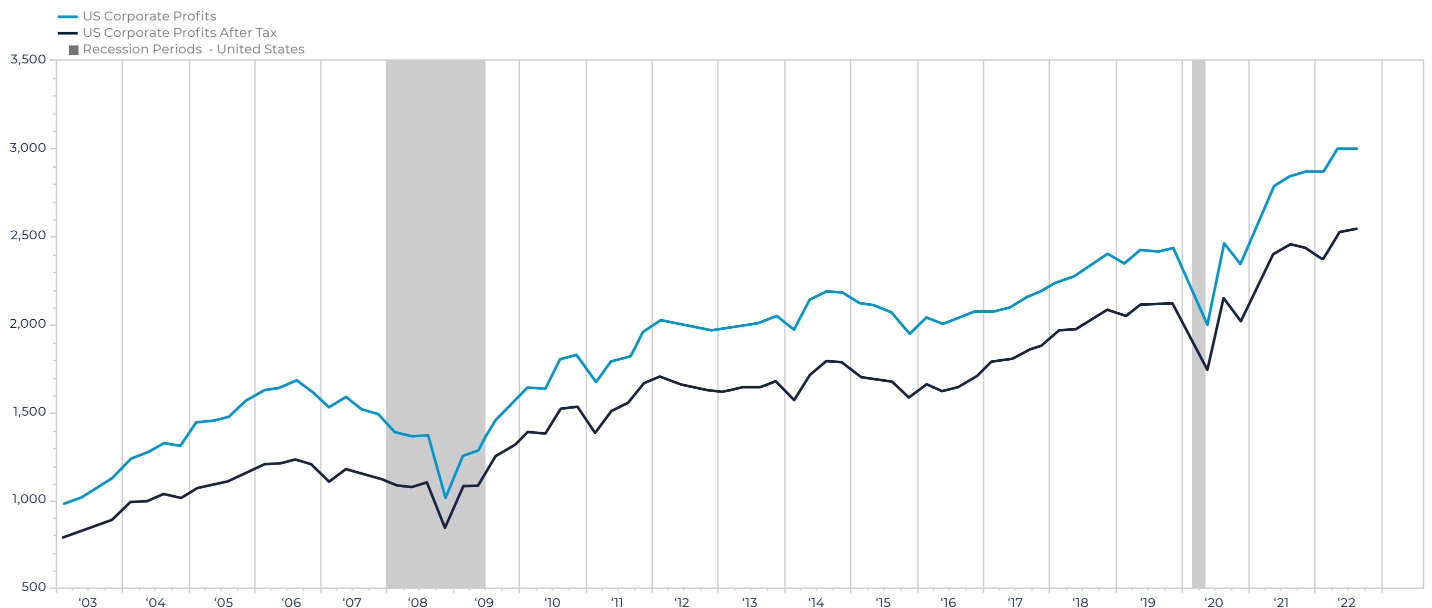


Source: Factset, as of 31/12/2022, Federal Funds Target Rate, Upper Limit
Factset, as of 31/12/2022, H.8 Assets of Commercial Banks, Loans & Leases in Bank Credit

CORPORATES AND THE CONSUMER

Importantly, US consumers and corporates have stayed strong throughout 2022 as they continued to spend and invest; the cornerstones of the US economy. More recently, consumer spending has been upheld by savings drawdowns as high inflation pressured real wages. However, cumulative excess personal savings are still estimated to be over $1tn. US corporates have also proven their resilience with earnings remaining near all-time highs, as shown in chart 8. Corporates and households are therefore running more robust financial surpluses than they have been prior to any recession since 1950 as debt service ratios still remain historically low despite rising interest burdens. Combining this with a strong labour market and falling inflation, leads us to believe that the US economy could narrowly avoid recession in 2023. As for Europe and the UK, whilst the corporate landscape is similar to that of the US, the consumer is not. Real incomes have been squeezed by high energy prices and the cost-of-living crisis has dented consumer spending. A mild recession in early 2023 therefore looks much more likely.

CHART 8
CORPORATE PROFITS ARE NEAR ALL TIME HIGHS



Source: Factset, as of 30/09/2022, National Income, Corporate Profits, Bil USD

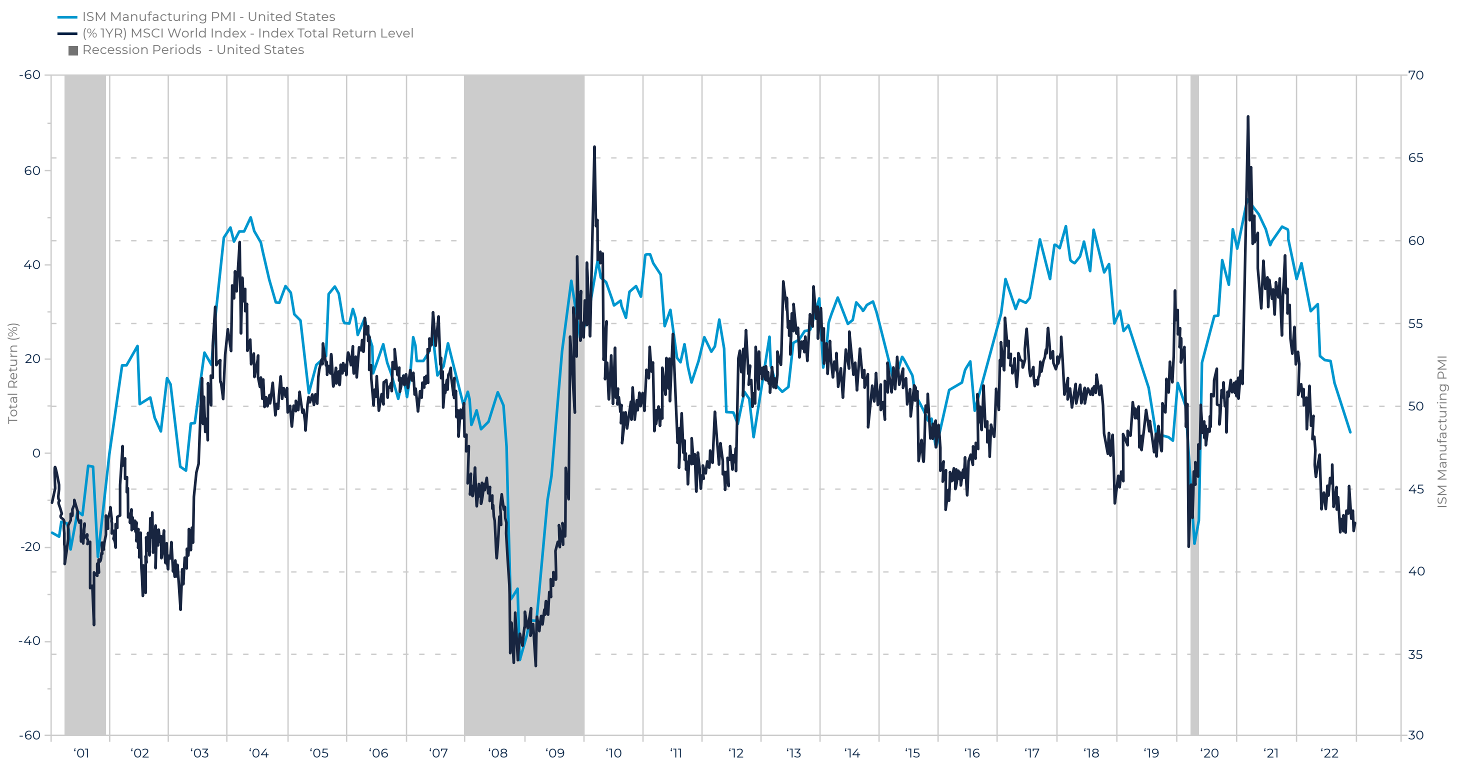
MARKETS ARE NOT THE ECONOMY

As we move into 2023, weaker growth, falling inflation and softer labour markets will likely lead to an end of central bank's hiking cycles. Whether rates will remain higher for longer, or central banks are quickly forced to pivot and start cutting rates will largely depend on how their respective economies hold up. For investors however, it is necessary to distinguish between markets and the real economy. Historical evidence suggests that the real economy suffers the greatest damage after interest rates have already risen i.e. higher rates take time to work through the system and therefore have a lagged effect on economic growth. Markets, however, are forward looking (6-18 months); selling off as they pre-price in the pain that is to come and rallying when they see signs of brighter days on the horizon.

Given the declines we witnessed in global equities during 2022, markets are already discounting an ISM Manufacturing Index of around 42 (a reading below 50 signals a contraction in manufacturing activity), as shown in chart 9. Furthermore, Bank of America's November fund manager survey showed 77% of managers anticipating recession. CEO's globally are also preparing for recession by trimming excesses, we are already seeing layoffs especially in the technology industry, suggesting a mild global recession lacks surprise power and is already priced in to markets.

Financial markets move on the difference between expectations and reality, and any dislocations will eventually be corrected. Calling the exact bottom of markets is an impossible task and the start of the new bull market will only be known in hindsight. Waiting for an all clear sign will leave you chasing markets. As Warren Buffet said in October 2008, **"if you wait for the robins, spring will be over"**. Markets currently lack real direction given the fate of global economies are still somewhat uncertain. Should a mild recession start to transpire, this should ease uncertainty, confirming what markets have already priced in, and allowing markets to move on and start pricing in the ensuing rebound in economic growth. Likewise, more evidence that a soft landing in the US is increasingly likely, could spark the new bull market rally. Bear markets on average last around 1 year, and short of a much worse than expected deterioration in economic output, we should see better equity markets in 2023.

CHART 9
GLOBAL EQUITIES ARE DISCOUNTING A MILD RECESSION



Source: Factset, as of 31/12/2022, MSCI World Index Returns (%1Yr)
US ISM Manufacturing PMI, as of 31/12/2022

Thank you for taking time to read our Market Review.

Sigma Investment Committee