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December 2022

Market Pulse

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EQUITIES RISE AMID MODERATING INFLATION AND HOPES OF A FED PAUSE

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Markets remained volatile in the fourth quarter. Equities generated positive returns; performance within fixed income was more mixed. In the early part of the quarter, continued upward surprises in inflation combined with hawkish rhetoric from central banks contributed to initial falls in equities and bonds, with both slipping to new year-to-date lows in mid-October. A change in tone from global central banks towards the end of the same month contributed to a recovery in both asset classes, as speculation grew that the pace of interest rate rises would soon begin to slow. By the end of November, global equities had recovered almost half of their year-to-date losses at the October lows. Both equities and bonds then fell again in December, with markets wary of recession risks in 2023 and central banks warning that policy would likely remain restrictive for longer.

Central bank policy

The US Federal Reserve (Fed) hiked rates twice over the quarter, the second hike slowing to 50 basis points (bps) from the previous 75bps. However, the central bank increased guidance for the terminal rate by 50bps, to 5.125%, which suggested another 75bps of rate rises before the Fed pauses. It also indicated rates will not be cut in 2023, in contrast to market expectations.

The European Central Bank (ECB) also raised rates twice, lifting the deposit rate to 2.0%. ECB President Lagarde indicated that further significant rate rises were planned, suggesting the market was discounting too few hikes. The ECB also announced that Quantitative Tightening (QT) will begin from March, whereby the ECB will allow its balance sheet to run off by approximately €15bn per month.

In December, the Bank of Japan (BoJ) announced a surprise increase in the target range for its 10-year yield to +/- 50bps. The BoJ indicated that the policy change was necessary to alleviate pressure in Japanese financial markets. The Japanese 10-year yield rose from 0.25% to a high of 0.48% after the policy announcement, before ending the year at 0.42%.

US economy

The US annual inflation rate appeared to have peaked, easing for the fifth straight month to 7.1% in November. The US labour market remained strong with non-farm payrolls rising by a higher-than-expected 256,000 in November. Sentiment surveys were mixed, with ISM manufacturing falling below 50 while ISM services rose to 56.6. PMI readings were weak, however, falling to the mid-40s. Retail sales were weaker than expected while industrial production also fell.

Speculation about a possible US recession in 2023 rose again in December following a US financials conference where comments from several large banks were relatively downbeat. Management from several financial companies spoke about the increasing likelihood of an upcoming recession with most suggesting they will need to reduce their workforces in response to recent signs of weakening activity levels in their main operations.

Eurozone economy

Eurozone inflation eased from a high of 10.6% in October to 10.1% in November. European sentiment surveys improved over the quarter and suggested that the expected recession could be milder than initially feared. The Eurozone composite PMI rose to 48.8; the EU economic sentiment reading also improved, as did the German ZEW and IFO surveys. However, the data remained weak in absolute terms and consistent with recession. Activity releases such as retail sales and industrial production were still in negative territory, though they showed signs of stabilisation; the European labour market remained strong, with unemployment falling to a new low of 6.5% and contributing to the third consecutive monthly rise in Eurozone consumer confidence in December.

China reopening

Having begun to ease its ‘zero tolerance’ Covid policy in November, China effectively abandoned the approach in December and rapidly moved to a full reopening of the economy. China will admit international travellers in January for the first time in almost three years. The sudden dropping of restrictions has led to a surge in Covid cases – some domestic institutions have estimated that up to 18% of the population contracted the virus over the first 20 days of December. There is significant self-isolation; therefore, despite official restrictions being removed, economic activity was weak through year-end. The economic reopening and support measures should, however, result in a strong recovery post-Q1 and through the remainder of 2023.

MARKET ROUND-UP

Equities

Over the quarter, the MSCI AC World equity benchmark rose 7.5% (0.9% in euros) as inflation appeared to peak and hopes grew that centrals banks would begin to pause rate hikes in early 2023.

The abandonment of China's 'zero tolerance' Covid policy and the expected full reopening of the economy in the first quarter also boosted sentiment around growth.

US equities lagged, despite rising 7.1% (-1.7% in euros), as some large cap technology companies suffered from a poor earnings season. US equities declined into year end as the Fed was more hawkish than expected, signalling that restrictive policy would be maintained for longer.

Europe ex UK equities rose 11.1% (10.3% in euros) as hopes grew that the recession in Europe might be milder than initially feared. Sentiment towards Europe also improved – gas prices fell and storage exceeded targeted levels, while Europe is seen as a leading beneficiary of any recovery in Chinese growth as the country reopens economically.

Pacific Basin equities rose 10.7% (6.2% in euros) on hopes for a recovery in Chinese and regional growth in 2023. Japan underperformed, rising 3.2% (4.0% in euros), as the Bank of Japan announced a surprise change in policy by raising the target range for the 10-year yield. The move generated concern over potential further tightening in coming months, and relatively disappointing economic news flow relative to other regions also acted as a drag.

Bonds

Global bonds were mixed during the quarter. The US 10-year yield rose from 3.83% at the end of September to a 15-year high in mid-October of 4.34%. It subsequently fell to 3.87% by year end.

European sovereign bonds were weaker over the quarter with the ICE BofA Merrill Lynch Eurozone >5-year sovereign bond benchmark falling -2.3%. Having peaked at 2.53% in mid-October, the German 10-year yield fell to 1.74% by early December as investors discounted a lower peak eurozone deposit rate of around 2.75%. However, the German 10-year yield rose to an 11-year high of 2.57% by year-end on the back of a much more hawkish European Central Bank (ECB). The ECB said further significant interest rate rises are anticipated, with market expectations for the peak deposit rate rising to 3.50%. The ECB also announced the start of quantitative tightening from March. The surprise decision by the Bank of Japan to increase its target range for the 10-year yield also contributed to the rise in yields into year end.

Peripheral spreads were volatile over the period. Despite widening in December on ECB guidance for tighter policy – both in terms of higher rates and the start of balance sheet reduction – peripheral spreads were lower over the quarter. Proposals to revise European fiscal rules with less onerous conditions contributed to the narrowing of the spreads, as did the more moderate stance of the new Italian government. By year end, peripheral spreads were lower compared to end-September levels, with Italian 10-year spreads against Germany at 213bps, while Spanish 10-year spreads were 109bps.

European investment grade (IG) corporate bonds rose 1.4% while global high-yield (HY) credit was up 4.4%. Higher sovereign bond yields pulled yields in European IG up 8bps, to 4.21%, although spreads narrowed 56bps to 164bps as hopes grew that the recession would be milder than previously expected. In corporate HY, yields fell 57bps through the quarter to 7.98% – benefiting from lower US yields from mid-October – while spreads fell 71bps to 414bps as economic data was more resilient into year end.

Emerging market (EM) local debt rose 0.5% as yields fell 47bps to 6.92%, benefitting from lower US yields from the middle of October. Weaker EM currencies against the euro acted as a drag on performance over the period. EM hard-currency debt rose 6.8% as yields fell 92bps to 7.80%, again benefiting from the downward trend in US yields from mid-October. EM hard-debt spreads also narrowed 107bps as sentiment towards EMs improved with the abandonment of China's 'zero tolerance' Covid policy. The country's economy is expected to reopen in early 2023.

MARKET ROUND-UP (continued)

Currencies and commodities

The euro was strong during the quarter with EUR/USD recovering from below parity to 1.0705. The dollar weakened in the more 'risk-on' environment. The Fed moving closer to the peak in interest rates for the cycle – with a pause in rate hikes expected in the second quarter – also contributed to a weaker dollar. Hawkish policy guidance from the ECB benefited the euro, as did reduced pressures in the European gas market and a growing belief that the European recession could be milder than initially feared.

Commodities rose 3.4% (-5.1% in euros), benefiting from the expected recovery in the Chinese economy as it fully reopens in 2023. Brent oil fell -2.3%. Oil faced several factors pulling in opposite directions which left the price only slightly changed over the quarter. Short-term weakness in China was offset by hopes for a recovery in growth in 2023. The agreement by the G7 on a price cap on Russian oil – of $60 per barrel – was offset by Russian suggestions that it would cut supply in response to the introduction of the cap. OPEC+ confirmed that it would maintain the 2 million barrel per day production cut announced previously, although this was offset by concerns around a possible global recession in 2023.

European gas prices remained volatile and were down 56.0%. Storage levels remained higher than initially anticipated as a cold weather spell across Europe ended.

Gold rose 9.8%, supported by a weaker US dollar and slightly lower US real yields. Metals were generally firmer on hopes for a better growth outlook in China through 2023, with copper up 10.7% and aluminium rising 10.0%

CHARTS OF THE MONTH

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 31 December 2022.

Bonds – German 10-year yield

Source: ILIM, Bloomberg. Data is accurate as at 31 December 2022.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	11.5	-21.1	17.1
MSCI United Kingdom	7.4	1.4	27.5
MSCI Europe ex UK	10.3	-11.9	25.4
MSCI North America	-1.6	-13.8	36.6
MSCI Japan	4.0	-10.8	9.8
MSCI EM (Emerging Markets)	0.8	-14.5	5.2
MSCI AC World	0.9	-12.6	28.1
10-Year Yields	**Yield Last Month (%)**	**2021 Yield (%)**	**2020 Yield (%)**
US	3.87	1.51	0.91
Germany	2.57	-0.18	-0.57
UK	3.67	0.97	0.20
Japan	0.42	0.07	0.02
Ireland	3.13	0.24	-0.30
Italy	4.70	1.17	0.54
Greece	4.62	1.34	0.63
Portugal	3.59	0.47	0.03
Spain	3.66	0.57	0.05
FX Rates	**End last month**	**2021 Rates**	**2020 Rates**
U.S. Dollar per Euro	1.07	1.14	1.22
British Pounds per Euro	0.89	0.84	0.90
U.S. Dollar per British Pounds	1.21	1.35	1.37
Commodities (USD)	**QTD Return (%)**	**YTD Return (%)**	**2021 Return (%)**
Oil (Brent)	-2.3	6.7	55.0
Gold (Oz)	9.8	-0.3	-3.4
S&P Goldman Sachs Commodity Index	3.4	26.0	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 January 2022.

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THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next 12 months is dependent on several factors including central bank policy, growth, inflation and geopolitical issues including the Russia/Ukraine crisis.

Equities struggled in 2022 amid slower growth, tighter monetary policy and higher bond yields. Such factors undermined the relative attractiveness of equities.

While the scale of monetary tightening and sharp rise in bond yields now seem discounted by equity markets, lingering growth- and earnings-related uncertainty may not yet be fully discounted.

While equities are expected to generate positive returns for the year as a whole, a better buying opportunity might present itself in the early part of the year as a slowing growth environment (with risk of earnings downgrades) could lead to further losses before a trough is reached in equity markets.

The greatest risk to equities relates to the potential for further downgrades to earnings forecasts in a slower growth/recessionary environment. Consensus forecasts are currently for earnings growth of 3% in 2023, which could be too high if the US and global economy enter a recession. Potential downgrades to earnings estimates in early 2023 could lead to further weakness in equity markets.

A potential offset to the risk of another leg down in equities would be evidence that the Fed and other central banks are achieving a soft landing, whereby they successfully lower inflation and manage to avoid a recession. If consensus economic and earnings forecasts prove to be correct and we are just in a mid-cycle slowdown, there is double digit upside in equity markets on a one-year view. A moderation in inflation with no additional policy tightening beyond what is currently discounted in markets – along with possible rate cuts at some point in 2023 – would be supportive of equity markets.

Even though a further dip in equities in early 2023 is possible, we believe the asset class can end the year higher. Equity markets are forward-looking and always discount ahead. With an eventual recovery in growth expected by the end of 2023/beginning of 2024, equities should begin to regain ground before mid-year. With returns in the initial recovery stage generally tending to be relatively strong, equities can generate positive returns for the year, even if they struggle somewhat in the early part of 2023.

Navigating equity markets is difficult even in a benign environment, but it is especially arduous given the current backdrop of heightened uncertainty on many issues. As a result, the increased volatility evident in 2022 is likely to continue.

THE MONTH AHEAD

JANUARY

			12 US Inflation Rate YoY (Dec)	13 GB GDP MoM (Nov) DE Full Year GDP Growth US Michigan Consumer Sentiment (Prel)
	17 CN Industrial Production YoY (Dec)	18 GB Inflation Rate YoY (Dec) US Retail Sales MoM (Dec) JP Interest Rate Decision		20 JP Inflation Rate YoY (Dec) GB Retail Sales MoM (Dec)
	24 DE GfK Consumer Confidence			27 US Personal Income MoM (Dec) US Personal spending MoM (Dec)
	31 FR Inflation Rate YoY (Prel Jan) DE Inflation Rate YoY (Prel Jan)			

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