Rathbones
Look forward

Review of the week

12 December 2022

2022 wrapped up

We look back at a grim year for financial markets. The rebound in the last few months seems to offer investors some relief, but can we be confident that the worst is over?

This year has been very grim: war, sky-high inflation, an energy crisis, a cost-of-living crisis, a stock market correction and increasing fears of recession. Even these latter fears failed to stop surging inflation and interest rates from sending bond yields soaring for much of 2022. We've become accustomed to some breakneck market shifts in recent years, yet they pale in comparison with the one we've just been through.

Fears that central banks might raise rates too much and strangle the economy drove big sell-offs across most equity markets for much of the year. Stocks rallied during the summer when investors (wrongly) began to expect an imminent pivot away from rate-raising. That rally fizzled out in the late summer, but appetite for stocks revived again in November when US inflation finally started to cool and central banks acknowledged that the pace of rate hikes might start to slow. Nevertheless, investors remain jittery as they look beyond inflation and the level at which rates peak and worry more about how bad the economy could get.

Inflation is in a topping-out process: a wide range of prices, such as freight, gas and other commodity costs, are falling sharply, while others are proving more sticky. And continuing labour supply shortages in the wake of the pandemic are keeping job markets very tight and supporting strong wage growth.

The Catch-22, of course, is that inflation overall is coming down because demand is falling away. To put it another way, we are used to rate hikes occurring because growth is strong. At the moment, growth is weak and getting weaker. This isn't a classic set-up for strong equity performance. We've barely begun to see the impact of lots of monetary policy tightening on economies and companies yet. Earnings downgrades and recession seem likely in 2023. For equity investors, the key question is: to what extent is this priced in?

We worry that consensus forecasts for earnings in 2023 look much too optimistic. They've fallen back only slightly, while double-digit declines in earnings forecasts are par for the course during recessions. Hardly surprisingly, it's rare for equities to perform well when earnings estimates are declining.

Weak growth and weakening earnings may keep equity markets volatile until they find a firmer footing when leading indicators of global economic growth have passed their trough and are about to turn a corner. And that seems unlikely until monetary policymakers have finished tightening and Europe's energy crisis starts to come to an end. Throughout history, equities have tended to deliver very attractive returns over the long term. Timing stock markets is notoriously difficult, but the declines in prices in 2022 do offer opportunities to invest in good companies at more attractive valuations. We continue to favour high quality companies with defensive characteristics. Companies that score highly on quality attributes are generally those that are more stable and profitable and, as a result, are expected to deliver higher or more predictable investment returns in tougher economic conditions.

China rolls back some COVID restrictions

As 2022 heads towards its finishing line, financial markets still have scope to deliver some surprises. Last week many Asian markets rallied sharply when China relaxed some of its extremely strident COVID-19 restrictions following widespread protests against rolling lockdowns that have been going on for three years now. China is still in a bind though. The reasons for its attempts to avoid widespread COVID infection remain: it has a very large, old population that has been cautious in its uptake of the homegrown Sinopharm vaccine, which is also less efficacious than Western varieties. Reducing restrictions will mean more infections and it's unclear how the country will be able to deal with the waves without either locking down again or accepting high casualties.

Chinese scientists have developed an mRNA vaccine, but it hasn't been approved for the mainland. The government has refused to use Western options and it seems unlikely to change course this late in the day. All this suggests that abandoning COVID restrictions completely could be very risky.

China's severe and repetitious lockdowns and restrictions have imposed big strains on its economy, which is also under pressure from the slow-motion implosion of its property market. Its road to full reopening is likely to prove both gradual and bumpy.

Thank you for investing with us through this bumpy year and for reading our weekly thoughts. We are taking a festive break and will be picking up the pen once more on 9 January. Happy holidays! As always, if you have any questionsor comments, or if there's anything you would like to see covered, please get in touch by emailing ***review@rathbones.com****. We'd love to hear from you.*

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