Quarterly Market Update

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4Q 2022

Five Key themes – Jan 2023

Growth risks to intensify

Continued declines in global PMI readings and a broad-based weakening of factory output across regions suggest that the global goods sector is in a recession, prompting comparisons to the 2000-2003 period during which there was a technology-led recession. Much depends on the inflation trajectory and the consequent impact on monetary policy in Developed Markets (DMs). While there are signs of inflation peaking, tight US labour markets and strong wage growth may force the US Fed to remain hawkish for longer. Meanwhile, high energy prices which have been another inflation driver will likely face more upward pressure especially as China begins to re-open, and this could prolong central banks' battle against inflation. On the flip side, exogenous factors leading to a decline in commodity prices could bring inflation down rapidly and end the monetary tightening phase earlier than expected. Nonetheless we believe the current conditions will likely extend into the first quarter of 2023.

Emerging economies relatively resilient

Central banks in Emerging Markets (EMs) have also tightened monetary policy, but generally not to the magnitude and pace seen in DMs. This is because for many emerging economies, domestic demand is typically weaker, wage growth is less robust, and hence inflation dynamics are relatively weaker compared to the US. This can be seen in China, which is experiencing weak domestic demand and weak inflation dynamics. Over in Asia, inflation has also been relatively benign partly due to the smaller fiscal stimulus response to the pandemic (unlike the US), less exposure to the energy shocks (unlike Europe), as well as more government subsidies, some of which have been passed onto consumers. Meanwhile Asian central banks have been trying to manage their interest rate differentials to contain currency depreciation and imported inflation.

Risk considerations

We believe the current market environment is quite challenging amid increasing tail risk events and geopolitical tensions. Geopolitical risk is notoriously hard to assess because it is dependent on the unpredictable behaviour of its actors. The Russia-Ukraine conflict in 2022 is perhaps a reminder to investors that following a decade of relatively peaceful geopolitical environment, we may be ushering in a new period of skirmishes caused by rivalry between great powers. Tighter liquidity conditions and higher borrowing costs are other key risks. As interest rates go up, companies that are not producing reliable profit streams will be most affected and vulnerable. Only companies that can produce an economic return from their borrowings are going to be creditworthy institutions. Finally, there is a good chance that the US Fed may push the US economy into a recession if inflation persists. Investors need to remain very vigilant to that potential outcome. The US dollar, which has strengthened considerably amid rising rates and souring global risk sentiment, will likely remain strong in the near term.

US Dollar performance during a recession

On a superficial level, the US Dollar (USD) tends to do well in recessionary scenarios as a counter-cyclical currency (i.e., when global economy weakens, the USD outperforms and vice versa; however, historically the outperformance is much stronger during a global recession (vs. a US only recession). Global recessions tend to coincide with US recessions, but there are notable exceptions, such as the 2001 dot com bubble and 1980 recession. In a global recession, equities fall substantially more than in a US only recession. The Fed usually cuts rate more than the rest of the world, however USD appreciates more via the "flight to safety" channel. In contrast with a US-only recession, equities' downside is more limited. The Fed still cuts more than the rest of the world, but in the absence of a strong flight to safety signal, USD trades lower alongside the Fed cuts.

Source: Eastspring Investments.

Revisiting the ‘60/40’ balanced portfolio strength

The attraction of the balanced portfolio, which typically consists of 50% to 70% of stocks and the remainder in bonds, is that it is able to deliver investors returns that are not too “hot” or not too “cold”, and with not too much volatility. However, following the losses in both global equities and bonds this year, the case for a balanced portfolio and the diversification benefits from such a strategy have come under great scrutiny. Though the “60/40” portfolio is currently tracking the worst YTD return (annualized) in the past 100 years, which was partly contributed by the rebound in inflation expectations, our analysis shows that the balanced portfolio has a significantly higher probability of beating a market timing strategy over the long term, even if the investment manager is highly skilled. Although it has been a challenging 2022 for the balanced portfolio, the historical relationship between equities and bonds will eventually re-assert itself. Afterall, it is when both equities and bonds are reasonably valued that they provide the most diversification benefits.

Source: Eastspring Investments.

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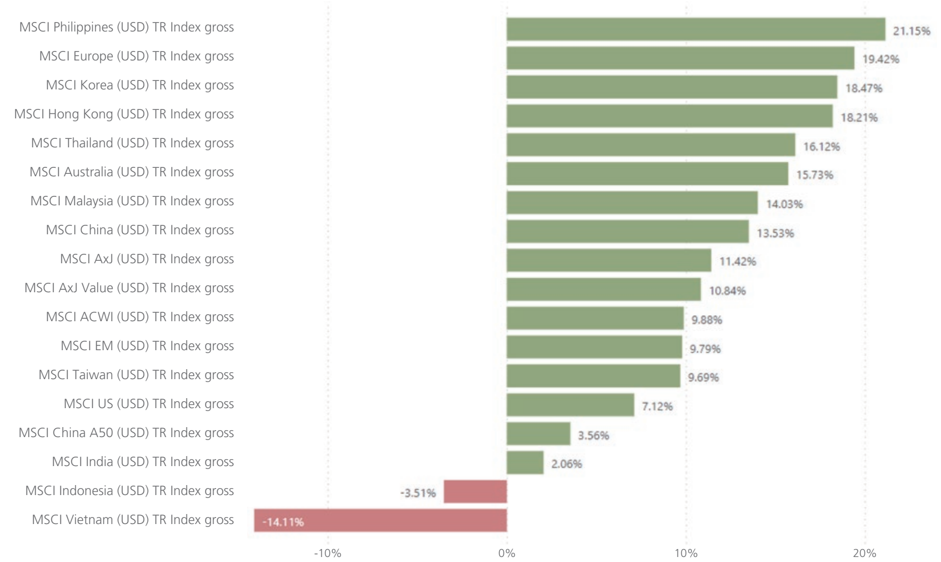
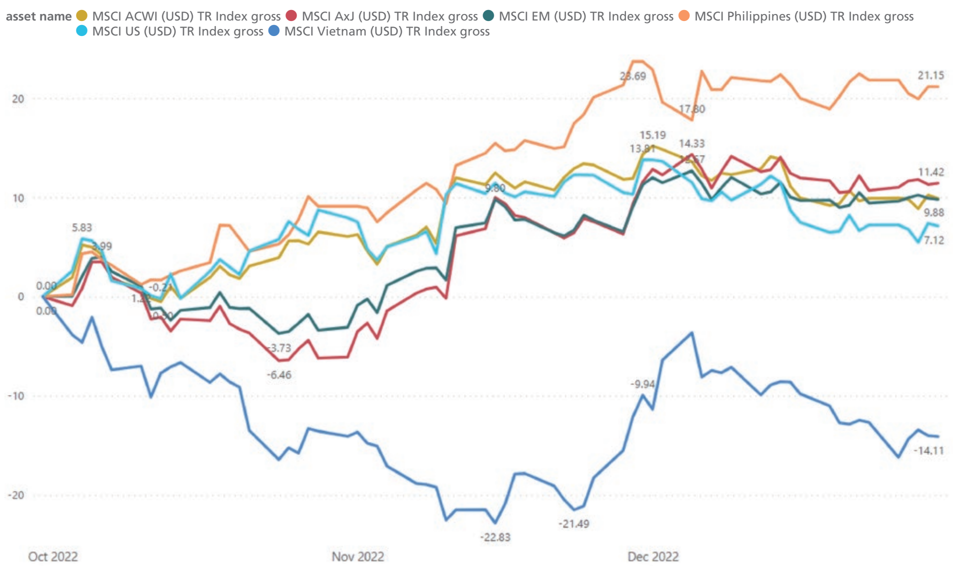
Equities

- Global equities rallied in October and November, but December marked a weak end to what was otherwise a strong 4Q22. The main engines of global growth – the US, Europe and China – experienced slowing economies due to continuous drag from the Russia-Ukraine crisis, inflation pressures and high interest rates engineered by central banks like the US Federal Reserve ("Fed") as well as China's aggressive plans to reopen its economy by scrapping its zero-COVID policy despite the rising COVID-19 cases.
- MSCI Indonesia and MSCI Vietnam bucked the trend ending the quarter on a negative note for 4Q of 2022, falling 3.5% and 14.1% respectively. The broader markets represented by MSCI ACWI (9.9%), MSCI EM (9.8%), MSCI Europe (19.4%) and MSCI Asia ex Japan (11.4%) all finished the quarter in positive territory. MSCI Hong Kong finished the quarter with strong double-digit return, up 18.2%.

Asset Performance Custom (30 Sep 22 till 30 Dec 22)



Asset Performance 30 Sep 22 till 30 Dec 22



Source: Eastspring Investments.

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Fixed Income

- In mid-December, the US Federal Reserve delivered a smaller 50bp rate hike to reach the highest level in 15 years and raised its projection of the peak Fed funds rate in 2023 by 50bp to 5-5.25%, showing slightly larger cuts in 2024 from that new higher peak.
- Returns across the various segments of the bond markets, much like the equity markets, were in positive territory. The Bloomberg Barclays Global Aggregate index finished the quarter up by 4.6%. The JACI Index finished higher by 3.3%. The JP Morgan EMBI Global Diversified index (8.1%) and the JACI non-investment grade index (11.3%) led the pack by finishing higher over Q4. EMBI markets are in a much better fiscal position this time round then has been the case in the past and continue to offer attractive valuation. Current 30-Year US Treasury Index (-2.8%) and 30 Year Bunds (-9.5%) were the laggards over the quarter.

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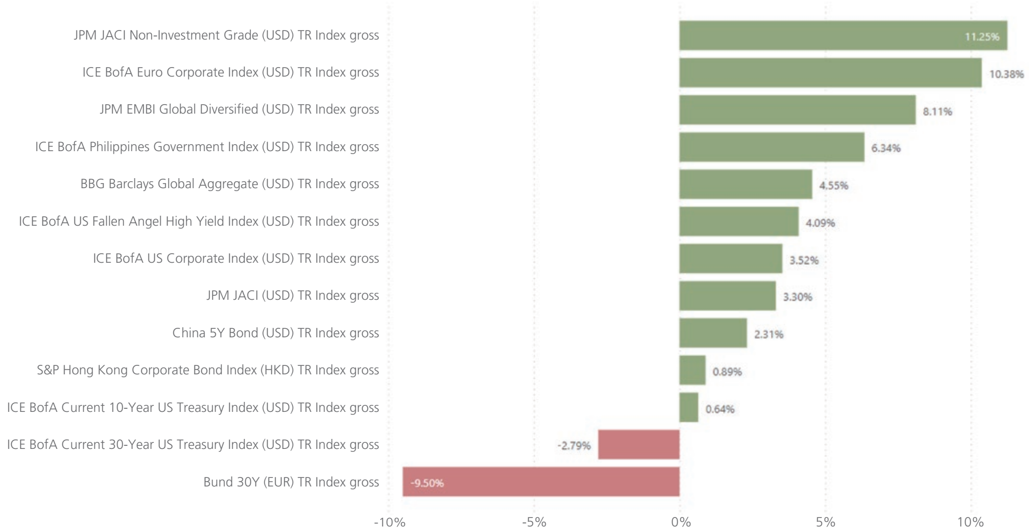

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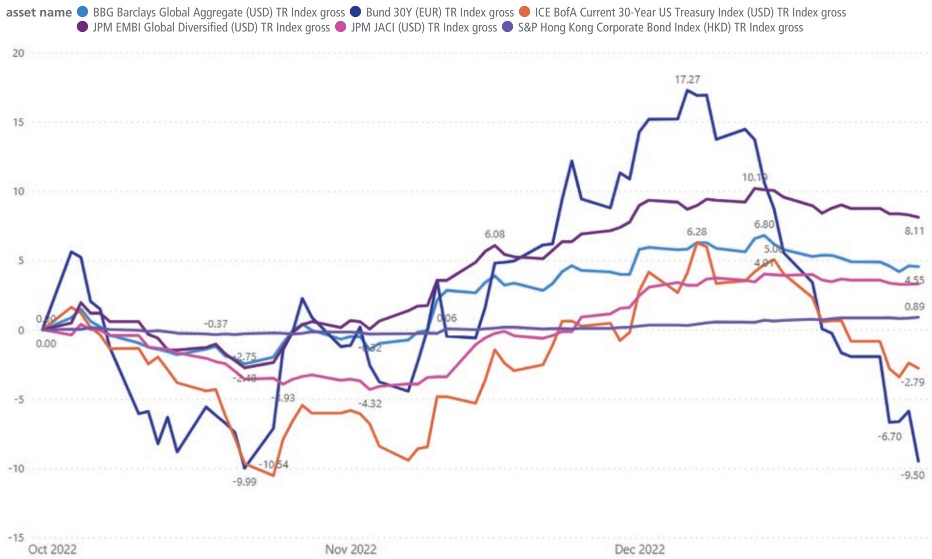

Source: Eastspring Investments.

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Currencies

- The US Dollar's strength paused over the last quarter of 2022 as it gave up ground broadly, with the INR being an exception (1.5%). The DXY index fell -7.7% in the fourth quarter and the Korean Won gained strongly against the greenback rising 12.4%. The Dollar slipped -9.3% against the Japanese Yen, and saw negative returns in other currencies as well, including British Pound (-7.8%), Thai Baht (-8.2%), and the Singapore Dollar (-6.6%).
- The Taiwan Dollar (3.6%), Yuan (2.0%) and the Malaysian Ringgit (5.0%), also gained relative to the dollar over the quarter.

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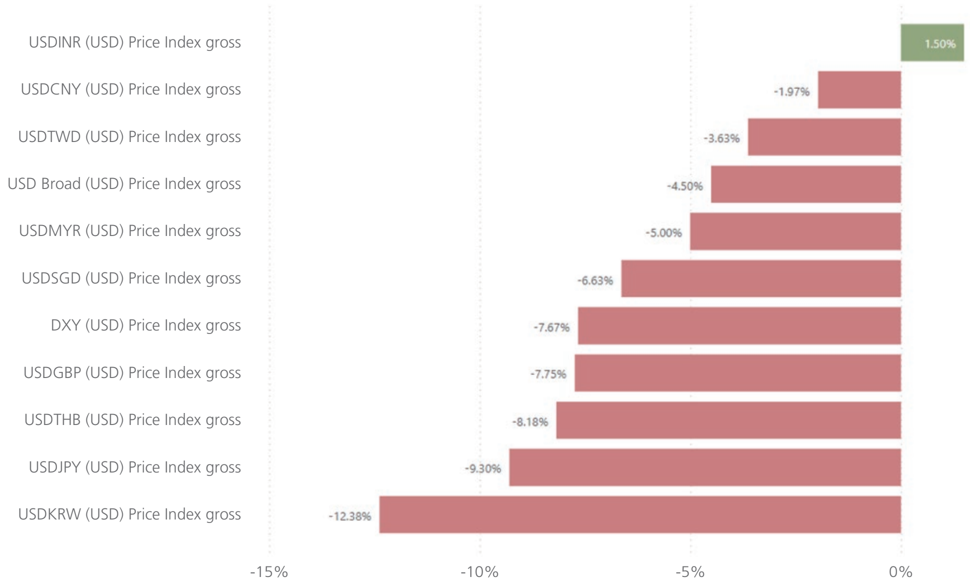

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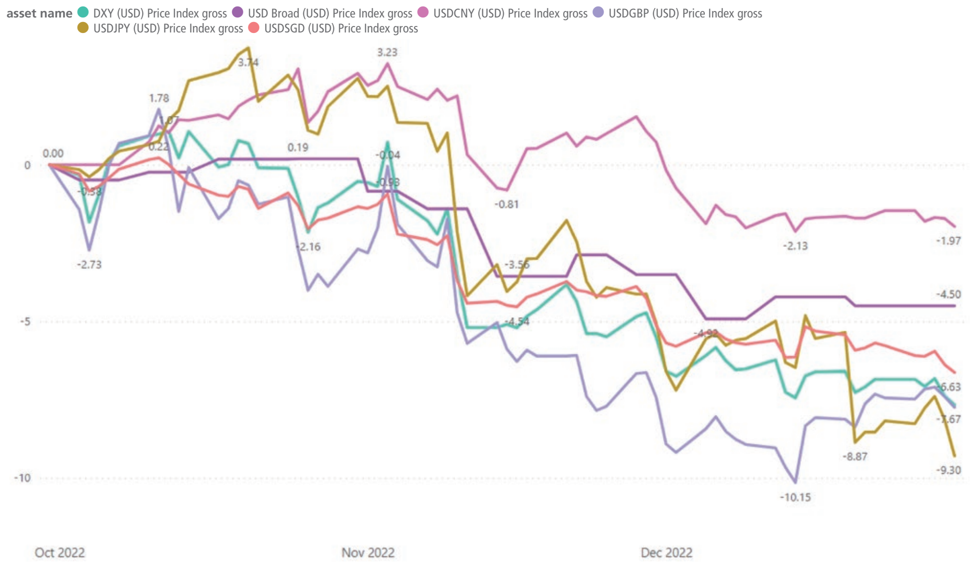

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Economics

- 2022 was an exceptional year, where only for the third time since 1926 both US stocks and bonds saw strong negative returns. The only bright spots seen in terms of major final assets, over the last year, were the US dollar and crude oil posting positive returns. The two assets rising in tandem was another anomaly as it is not what we usually expect to see, as these assets tend to have an inverse relationship. It does however highlight that, inflation and hawkish central bank policies around the world were the key factors behind what drove the financial markets in 2022.
- Going forward, we may see a more benign economic backdrop in the second half of 2023 when we will probably be past peak inflation and peak US Fed hawkishness. This environment should be positive for risk assets but the actual path for inflation and its impact on monetary policy will continue to drive markets in 2023.

Source: Eastspring Investments.

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