# INVESTMENT UPDATE

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FOR PROFESSIONAL INVESTORS ONLY

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## Investment Update

Recession warnings and a rising stock market seem at odds with each other – our latest update seeks to unpack this conundrum.

January so often typified by post festive sobriety and abstinence has proved quite different at an investment level in 2023. The year began quietly as expected, then investor "animal spirits" reappeared, stimulated it seemed by China's economic reopening and the US CPI inflation print which pointed to looser monetary policy before too much longer. A decent month for risk assets has resulted across a broad base and will be a pleasing start for investors after one of the toughest years in 2022. However, perhaps a little too early to announce victory.

US CPI inflation was reported at 6.5%, down from 7.2% the previous month and was in line with expectation. However, on closer inspection the underlying drivers have weakened significantly which is positive indeed. Later in the month the central bank preferred measure of PCE inflation also shrank back as expected and continues to support our thesis that in America inflation is subsiding quickly. Leading indicators such as yield curve inversions across a range of tenors, Purchasing Managers Indices and US Conference Board data all point to a steep slowdown or recession.

The expectation for US rates to peak anytime soon was challenged by Federal Reserve Chairman Jerome Powell. US rates were raised 0.25% as expected, firmly restating the inflation target/goal of 2%. The Fed pushed monetary policy further into restrictive territory but slowed the pace of increase notably as it made positive steps towards controlling inflation. The benchmark rate is now in a range 4.5% to 4.75%. This rise marks a second downshift from the Fed following a slowdown to 0.5% in December after four consecutive 0.75% hikes.

A tight labour market remains a feature which the Federal Reserve would no doubt like to see weakening before any real pivot in rate setting policy is announced. The early signs of so-called operational leverage are in play with thousands of lay-offs across the technology sector in January alone.

The US dollar continued its downward rerating in January which is of course positive for risk assets, with the DXY (Dollar Index) standing around 101 presently. We will aim to implement a hedged strategy in the near term when conditions are right, as we have pointed to in previous updates.

Valuation remains an important consideration and the S&P 500 is certainly not trading in attractive territory with a forward PE ratio of 19x earnings. If we remove some of the major technology names, such as Apple, Microsoft etc then the picture improves to a more reasonable 14x forward earnings for the 496 largest companies within the S&P 500. Such is the skewed importance of the larger growth-oriented companies here. Despite recent falls Apple and Microsoft are individually worth more than the entire German stock market. The CAPE ratio which incorporates inflation and compares across a longer period also suggests stocks are not yet cheap. So, we turn next to earnings to determine whether the likely pressure on stocks is positive or negative. The quarter 4 earnings season in America is in full swing as we pen this note – offering us a view of more patchy but broadly positive results so far and shown in the table below published on 27th January. Of course, structurally weaker earnings put further pressure on valuations and could well see equities trading lower should deeper earnings weakness result.

## S&P 500: EARNINGS

Exhibit 2. 2022Q4 Earnings Scorecard

| Sector | Above % | Match % | Below % | Surprise Factor | Reported Total # | Index Total # | % of Mrkt Cap |
|---|---|---|---|---|---|---|---|
| Consumer Discretionary | 70% | - | 30% | 8% | 10 | 56 | 10.4% |
| Consumer Staples | 64% | 9% | 27% | 3.1% | 11 | 33 | 6.7% |
| Energy | 71% | - | 29% | 0.2% | 7 | 23 | 5.3% |
| Financials | 60% | 5% | 36% | 0.8% | 42 | 67 | 11.7% |
| Health Care | 75% | - | 25% | 5.1% | 8 | 64 | 14.8% |
| Industrials | 64% | - | 36% | -3.5% | 25 | 70 | 8.3% |
| Materials | 75% | - | 25% | 7.1% | 8 | 29 | 2.8% |
| Real Estate | 67% | - | 33% | 3.5% | 3 | 30 | 2.8% |
| Technology | 86% | 5% | 9% | 1.9% | 22 | 76 | 26.6% |
| Communication Services | 40% | 20% | 40% | 1.8% | 5 | 22 | 7.8% |
| Utilities | 100% | - | - | 3.3% | 2 | 30 | 2.9% |
| **S&P 500** | **67.8%** | **3.5%** | **28.7%** | **1.6%** | **143** | **500** | |

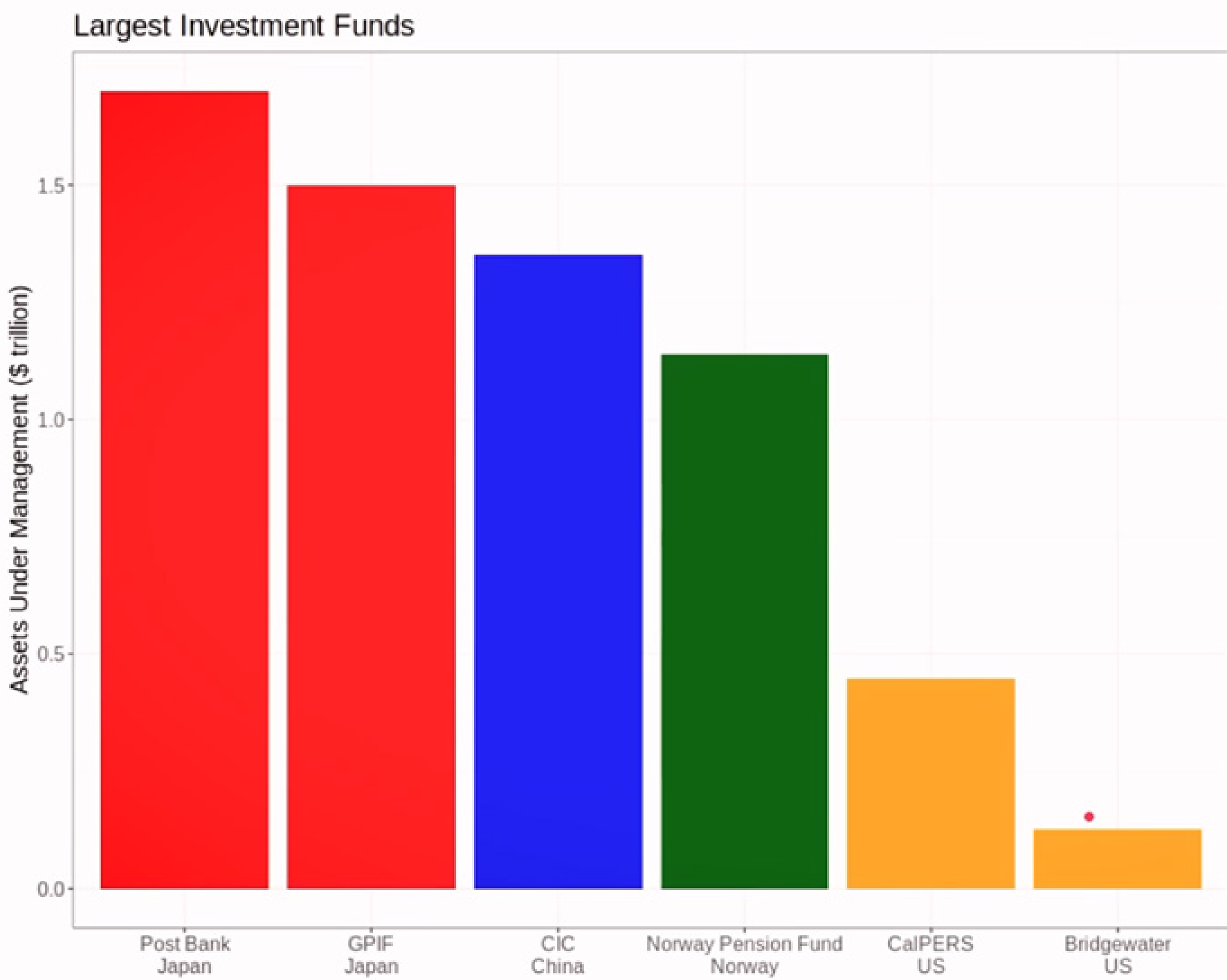
*Source: Refinitiv, as at Q4 2022.*

Despite the less than sparkling flow of corporate earnings with progress so far around 4% down, US markets have pushed higher breaching the important 200-day moving average and holding firm. For now, at least.

Much of the positive momentum has come from a new short dated options trading facility in the US. Record numbers of so-called zero-day options that track the S&P 500 stock index are changing hands – with volumes of about 1.5 million per day in November and more than four times the volume than 2020, according to OptionMetrics.

In Europe the ECB has adopted tough rhetoric when talking about inflation management akin to that of the Federal Reserve. On 20th January Mrs Lagarde (ECB Head) stated they would “stay the course” in the fight against inflation with Eurozone rates set to rise further during the year. Eurozone rates are projected higher to around 3.5%, perhaps peaking mid-2023. However, the pullback in inflation driven by falling energy costs, particularly liquid natural gas, has buoyed sentiment and stock prices in Europe too. Fourth quarter GDP proved positive which was a positive surprise. At home in UK, wage pressures and food costs continue to occupy the minds of policy makers as industrial unrest spreads. Rates are likely to trend higher for longer consequently and UK finds herself lagging other economies on the forward view.

Moving now to Japan where inflation nudged up marginally to 4% in January, a 43-year high. As described here last month, higher inflation has provoked the Bank of Japan to amend the trading range for Japanese Government Bonds which should allow for subtly higher interest rates downstream. However, side effects such as of causing Japanese investors to keep assets at home rather than overseas is an area we will need to keep under surveillance. Japanese sovereign wealth funds are extremely large when measured on a global scale and typically diversify their holdings on a wide geographic basis.




*Source: Pensioncraft January 2023.*

China's economic reopening is perhaps the single most positive item of news in the short year-to-date with positive knock-on consequences to global GDP and particularly to those nations with an enhanced trading relationship. Commodity prices pushed higher consequently in anticipation of resumed demand increases for industrial components, such as copper. Pent up demand following lengthy lockdowns is bound to drive consumption whilst the Peoples' Bank of China deploys an accommodative stance to drive GDP towards the 5.5% target. The potential for peaking then lower rates in the US will of course have material positive consequences to those nations borrowing in US dollars. A higher portfolio allocation could well be justified based on supportive policy by the Federal Reserve.

In summary, a good start to the year for investors with portfolio performance ahead of our peers* across the Alpha Beta Core and Core Plus portfolio ranges. We urge caution before celebrating a victory over inflation anywhere in the world at this point. Portfolio positioning, for now at least, remains defensive. We are poised to review allocations and dollar exposures when the opportunity is best rewarded and look forward to updating you again soon.

**Written by the Alpha Beta Partners Investment Team**

** Source: Morningstar As at 31 January 2023*

*Unless otherwise stated all data sourced from Bloomberg*

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*The Five Diamond rating awarded on Alpha Beta's Core portfolio range.*