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CIO INSIGHTS

9 February 2023

December 2022 had most, if not all, analysts, strategists, and houses calling for a bleak first-half of 2023. And, as we are only one month in, they may yet prove to be right. Having said that, often, a unanimous and unambivalent chorus leads to the opposite reality.

That does seem to be the case for now: if all market participants are bearish and have sold, then, on margin, there is no new player coming in to sell and ergo, prices go up. As a result, we have not been surprised by the direction of the price action even though the pace has been quicker than expected.

We have reiterated over the last few months the possibility of a disconnect between pessimistic headlines and soundbites of job losses and slower economic momentum / data coupled with rising asset prices. This seeming anomaly, again, can be easily explained. The twelve months of 2022 had every conceivable problem thrown at investors.

From, more-hawkish central banks, to stubborn decade-high inflationary levels, to the war in Eastern Europe which led to soaring energy prices and disruptions, unending chatter of an invasion of Taiwan and likely the largest human lockdown in history playing out in China, along with concomitant disruptions and additional price pressures.

Leaving aside the severe drawdowns in the equity markets, the epochal negative performance of the bond market left investors bruised and confused. The fixed income markets are just not meant to work the way they did in 2022. Hence, with continued selling over the last year it has been easy for prices to shoot higher; marginal buyers have been more aggressive than marginal sellers.

This represents the proximate answer to the unexpected rally. It is also helpful to take a step back and look at the market environment in its larger context to discern how the rest of the year might play out.

Revisiting the Global Financial Crisis (GFC) of 2007 – 2009, the advent of new-fangled tools (Quantitative Easing or QE) helped rescue the global economy from a crisis of massive proportions but also induced a heady hangover during which many investors chased companies and assets that represented pipe dreams rather than viable businesses. Over the next decade and a half this led to tweaks and experimentation in the laboratory of all-things financial. From the European Sovereign Crisis to continuing deployment in the land of its birth, Japan, the extra flow of liquidity tamped things down and greased the cogwheels of the system.

A couple of bumps along the road have cemented central bank intervention (through the mechanism of “creating” money to buy bonds) as the go-to tool for policy makers dealing with crises. First, a twenty-four-hour US money market meltdown in September 2019 - not known nor remembered by many – led the Federal Reserve to engage in large interventions in the money markets to stabilize the system (* link below).

In March 2020 the all-too-familiar Covid-induced dysfunction led to multiple levers being pulled that inevitably left central bank balance sheets more bloated.

*(Wikipedia September 2019 Events - U.S. Repo Market)

Leaving aside the obvious scams, multiple assets traded at unhealthy valuations. Remember negative yielding bonds? Those once accounted for around $ 18 trillion of assets. Today, not so much. The positive momentum that led to higher prices and poorer valuations had to end. From the equity markets to the nascent crypto world to bonds. We are now in the process of correcting that misalignment of valuations.

This begs the obvious question: When does this process, of realigning valuations closer to something resembling “normal”, actually end?

We keep an eye on the following factors to formulate the answer:

- Central bank balance sheet contraction – what is the eventual goal and pace that policy makers have in mind? With the Federal Reserve, for example, is the target the pre-Covid $ 4 trillion or the pre-GFC $ 1 trillion? What timelines are being considered?
- Fiscal policy – are governments able to support and invest in projects that produce positive multiplier effects for the economy?
- Taxation policy – are authorities better able to plug loopholes and enforce compliance and reduce debt loads?
- Social unrest – while these questions are being answered, do governments ensure that lower-income groups are not left with the heavy pulling?
- Geopolitics – what do the tectonic shifts underway lead to for the various players involved?

Back to where we kicked-off, explaining the events and price action since the start of 2023:

With the excessively bearish backdrop and consensus of 2022 there was always a decent probability that the obverse would play out. It did.

Having said that, risk assets are higher despite still hawkish language from central bankers. Various Fed Governors have pushed back on lower rate expectations. The European Central Bank has hiked rates and indicated additional hikes in the pipeline. The Reserve Bank of Australia hiked again this week. We ponder tighter policy even from the Bank of Japan. With this reality there is a ceiling to exuberance and a natural limit to any rally.

Barring unexpected geopolitical shocks, we believe there is value to be found into price declines and continue to take a tactical approach to markets - play the upside when the mood is overly despondent and lock in gains into rallies.

With the end game for rate hikes nearer rather than more distant and with volatility closer to historic lows – after being elevated for the last twelve months - we are incrementally optimistic about outcomes for 2023. Given the overall levels of uncertainty, we continue to have hedges in place to help manage “unknown unknown” scenarios.

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