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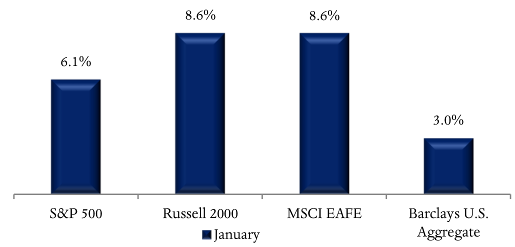
Markets

Global financial markets experienced a strong start to 2023. Slowing inflation strengthened market hopes that central banks would soon end their interest rate hiking campaigns. In the US, the bellwether S&P 500 index rose +6.1% during January, while the smaller capitalization Russell 2000 rebounded by a healthy +8.6%. A notable resurgence of trading activity jolted the tech-heavy Nasdaq composite higher by +11.1%, its best January in 22 years. Conversely, defensive sectors such as healthcare, utilities and consumer staples, which feature more heavily in value indices, trailed. Overseas, developed market stocks in the MSCI EAFE index rallied +8.6% last month, while emerging market equities advanced +10.0%. In Europe, the Stoxx 600 rose +7.2%. In Asia, Chinese stocks in the Hang Seng index were the star performers, rocketing higher by +14.7% on the back of post-pandemic reopening euphoria.

Bonds also rallied in January as yields fell along the back end of the curve, leading the Global Aggregate bond index to rally +3.2% (+3.0% for its US counterpart). The prospect of less restrictive monetary policy and a weakening economy boosted demand for fixed income and caused US Treasury yields to fall, with the 10-year ending the month at 3.51%, down from 3.88%.

The relatively mild winter in Europe and importation of LNG has helped bolster regional gas storage which, at the end of January, was approximately three-quarters full, compared to 35% a year ago. Further, the average price for natural gas in January was about 55% lower than that of the second half of 2022. This chain of events has thankfully defused the energy crisis in Europe but produced a headwind for associated commodity prices. WTI crude oil traded $78.87 per barrel (-1.7%) at month end, driving the S&P GSCI index lower by -0.7%. Meanwhile, gold shone, rising +5.7% to $1,927.88/oz.



Geopolitics

On the Russia-Ukraine warfront, Moscow has intensified its campaign to capture the entire Donbas region, with fierce fighting concentrated around the now deserted city of Bakhmut. This escalation appears to indicate that Russia is in the early stages of a new offensive. Meanwhile, Ukraine's Western allies are speeding up the delivery of ever more advanced weaponry, including dozens of US and German tanks as well as sophisticated missile systems. Ukrainian officials have also started to press NATO officials for fighter jets to enable its military to pose a longer-distance threat.

At the Davos 2023 World Economic Forum, global leaders and business executives imparted a sense of cautious optimism. The risks to their outlook include inflationary pressures from China's reopening, potential debt distress in the developing world, and the onerous path of getting inflation down to the 2% target set by central banks. The reimagining of globalization and "friend-shoring" was a notable topic. The United States pitched its vision of "worker-centric" trade, China promised an "all-round opening up" and Europe spoke of its quest for strategic autonomy. All that played into the fixation at Davos on the $369 billion US Inflation Reduction Act to tackle climate change, the potential for leaving certain emerging markets behind, and Europe's fears that it will divert clean tech business from elsewhere, to the United States, at its expense.

United States

Narrative of a potential soft landing picked-up steam as the US produced annualized GDP growth of 2.9% during the final quarter of 2022, mainly driven by consumer spending on services. However, final sales to domestic purchasers grew at a subdued 0.8%, indicating that growth momentum is slowing. As consumers face a higher cost of living, the personal saving rate declined to 3.4%, far below the 7.7% pre-pandemic average. Further, as households attempt to maintain their standards of living in times of sharply rising prices, credit card debt rose by 15.2% year-over-year. As the excess pandemic savings cushion rapidly dwindles, the aforementioned trends should eventually result in lower consumer spending.

The US labor market accelerated at the start of the year as broad-based hiring added a robust 517,000 jobs and pushed the unemployment rate to 3.4%, a 53-year low. Despite the strong hiring, wage growth softened, as January's average hourly earnings grew 4.4% from a year earlier, down from 4.8% in December. With regard to labor's effect on inflation, productivity increased an impressive 3.0% in the fourth quarter, after being negative for the first half of 2022, as output increased 3.5%, offset by 0.5% more hours worked. If this trend continues, it would alleviate some of the pressure on corporate profit margins from higher labor costs, easing inflationary pressures. Corroborating the trend, core personal income expenditure (PCE) rose at a 3.9% annualized pace, a deceleration from 4.7% in the prior quarter.

These economic data points and trends led the Federal Reserve to raise its benchmark rate by a further quarter percentage point, to a range between 4.50% and 4.75%. The central bank is on track to raise interest rates by another 25 basis points at its meeting next month, with the potential for a subsequent increase.

Recent US housing activity data is showing the effects of increasing interest rates and lower affordability. Existing home sales declined 1.5% in December, to an annualized rate last seen at the depths of the pandemic, with the median sales price falling for the sixth straight month. Likewise, single family home-building permits fell for the tenth consecutive month.

January 2023 Economic Statistics

	Jan-23	Dec-21	Dec-20
Federal Funds Target Rate	***4.50 - 4.75%***	0 - 0.25%	0 - 0.25%
Consumer Confidence Index	***107.1***	115.8	88.6
Manufacturing PMI Index	***47.4%***	58.7%	*60.7%*
Unemployment Rate	***3.4%***	3.9%	*6.7%*
JPY/USD	***130.09***	115.08	*103.24*
USD/EUR	***1.0862***	1.1368	*1.2213*
Gold/oz.	***$1,927.88***	$1,828.39	*$1,896.49*
Oil (WTI)/bbl	***$78.87***	$75.21	*$48.52*

Europe

Indicators of economic activity in the eurozone surprised to the upside in January. The composite purchasing manufacturers' index (PMI) transitioned to an expansionary 50.2%, signaling a significant improvement in sentiment. The region might avoid a winter recession thanks to benign weather and government energy support measures. Consumer sentiment echoed this development with the fourth consecutive monthly improvement since the September 2022 all-time low. Inflation fell to 9.2% year-over-year in December, the second consecutive drop and the lowest print since August.

In the UK, the latest gauge of inflation dipped to 10.5% year-over-year from 10.7% prior, while the core measure was steady at 6.3%. Energy and goods inflation eased, while service inflation rose, as wage growth remained robust. Business surveys continued to indicate that a recession is likely. The UK has a higher proportion of people on floating or short-term fixed rate mortgages which will squeeze their spending as interest rates rise. However, it is interesting to note that there is a high percentage of homeowners whose properties are unencumbered.

Asia

China's surprisingly rapid pivot away from its zero-

Covid policy has raised expectations that the second largest global economy will experience a strong and imminent recovery. Expectation call for 5% GDP growth for the full year 2023, up from 2.9% in Q4 2022. In December, infections peaked after lockdown measures were relaxed across the country, leading retail sales and industrial production lower by -1.8% and -1.3%, negatively affected by labor shortages. By late January, just prior to Chinese New Year, mobility data indicated that subway passenger flows had recovered to 60-70% of pre-Covid levels in Beijing and Shanghai, and exceeded peak levels in Shenzhen. The government's infrastructure investment push and monetary easing supported fixed asset investment, which remained relatively stable at 3.1% over the year-ago period. The expected economic acceleration in the first half of the year should also benefit China's regional trading partners, and help debottleneck the global supply chain. In line with the experiences of the rest of the world, there is a considerable amount of excess savings and pent-up consumer demand in post-pandemic China.

Japanese inflation accelerated to 4.0% year-over-year, the highest reading in 31 years. As a result, the Bank of Japan loosened its yield curve control, widening the band for 10-year government bonds from +/- 0.25% to +/- 0.50%. However, during the month the BoJ had to massively intervene in the bond market to defend the new limit because investors are anticipating a further adjustment. As a consequence, the central bank's balance sheet expanded significantly for the period, dwarfing the quantitative tightening of the Federal Reserve, an anomaly that warrants mention.

Outlook

The 2022 bear market in stocks, and crash in bonds, created attractive entry points for investors in both asset classes. The subsequent equity rebound off the summer lows has been a powerful one, defying skeptics, by going against the tightening monetary conditions of global central banks and the accompanying higher interest rates, amid stubborn core inflation and the expectation of impending recessionary conditions. However, inflation is trending down, which should allow the Federal Reserve to cease raising interest rates in the near future, leading to a soft economic landing, or even continued growth, in the US. The end of China's zero-Covid policy and a surprisingly resilient European economy, aided by plummeting energy prices, should support those local corporate earnings. However, the downside risk from the improved growth outlook would be if it leads to persistent inflation and a longer period of peak interest rates.

From an equity allocation decision making perspective, corporate earnings are expected to come under pressure in 2023 while valuations have rebounded towards the upper end of the historical range (the S&P price to earnings ratio has reached 18, while the price to sales metric is 2.4 which is higher than the dot com peak). Similarly, the US market cap to GDP ratio is currently at 153%, using the broad Wilshire 5000 index, also greater than the 2000 internet bubble's peak, and three times the level of the 2009 GFC market low. This paradoxical market environment merits continued investor caution, at least at the index level. While value stocks are statistically cheaper and should perform well with a medium term time horizon, they too may suffer in the face of an economic slowdown. The upshot is that stock-picking strategies have much improved prospects to exceed benchmark returns over the coming years.

Fixed income and credit markets presently offer some compelling opportunities on the back of higher yields and wider spreads. Commodities, especially energy and agricultural related ones, should benefit from supply shortages stemming from extended periods of underinvestment and associated bottlenecks. For long-term investors, seeking to capitalize on disruptive technology trends, there are opportunities in the food and beverage, edu-tech and cybersecurity sectors. We would also point to the robust growth prospects of the disruptive companies in our Nordic Technology and Innovation Fund, whose valuations have contracted meaningfully.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.