FFG

FORUM FINANCE

1994

INVESTMENT PERSPECTIVES 2023

JANUARY 2023

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EXECUTIVE SUMMARY

2022 was one of the most challenging years ever for investors

The past year was a brutal one for investors. The tightening of monetary policies was not a surprise, but it proved to be far more pronounced and damaging than anticipated for many asset classes. This fast-paced tightening of monetary policies, due to ongoing inflation pressures, and the war in Ukraine were the main drivers for the significant weakness of markets. China's zero-COVID policy provided another headwind as its economy fared much worse than forecast. In a risk-off environment, there was hardly anywhere to hide, and this was reflected by the dreadful performance of US Treasuries, considered to be amongst the safest of assets. Volatility in the bond markets reached crisis levels and remained very elevated for most of the year. This stress spilled over to the other asset classes, and the high level of correlation between equities and bonds meant that diversification failed to protect well against portfolio losses.

The breath-taking speed of the Federal Reserve's monetary policy tightening

2022 will be remembered as the year when the era of extremely accommodative monetary policies finally came to an end. Since the great financial crisis, the major central banks had lowered interest rates to zero, or even into negative territory. Investors had been expecting interest rates to rise and central banks' balance sheets to contract in 2022, but they were not prepared for what took place effectively. The Federal Reserve's shift from a very accommodative monetary policy to a very restrictive one took place in a matter of months only, as the size of rate increases quickly rose from 0.25% in March to 0.75% at four consecutive FOMC meetings between June and November. The US central bank hiked its rates by a total of 4.25% in 2022 to a range of 4.25% to 4.50%, with other major central banks taking a similar path, even if not at the same pace. The latest interest rate decisions and communications from the main central banks have confirmed their hawkish stance and determination to bring down inflation.

Investors will remain focused on inflation trends and geopolitics

GDP growth is expected to slow in 2023, with a high risk that the global economy could slide into recession as growth expectations for the United States and Europe are very low or negative. Much will depend on the pace of deceleration of inflation and the trajectory of interest rate increases. The task of central banks around the world is extremely challenging and the risks of a damaging policy mistake are much higher than average. Economic prospects could be boosted if China finally manages to reopen its economy successfully. Geopolitical threats remain elevated. There are many sources of tensions across the world, but one cannot exclude the possibility of some unexpected positive developments even if we are not holding our breath.

Amid elevated uncertainty we maintain a cautious asset allocation

The tightening of monetary policies has erased some of the markets' distortions and excesses of the previous years, meaning that fundamentals should matter more now that the era of easy money has come to an end. Valuations have improved for most asset classes, but uncertainty remains prevalent on many issues. Despite last year's derating, equities still face headwinds. That largely explains why we have maintained our overweight allocation to alternative strategies and have increased our fixed income exposure recently in view of its improved risk/return profile.

2022: REVIEW OF OUR INVESTMENT THEMES

Our base case scenario was shattered by some unpredictable events

When revisiting our 2022 capital markets' forecasts, it is clear that our cautious outlook on the prospects for financial markets' performances still proved to be far too optimistic. We had not foreseen the war in Ukraine and this dramatic development obviously added a risk premium across most asset classes. China's strict management of the pandemic was also another issue that dragged on for much longer than expected. This contributed to the ongoing disruption of supply chains and had an impact on inflation pressures. While our assumption that equity valuations would continue to decline was correct, we believed that equities would hold up better, nevertheless, thanks to solid corporate earnings and corporate buybacks. Earnings were resilient effectively, but the very restrictive monetary policy of the Federal Reserve proved to be too much of a headwind, however, and we had not anticipated such a radical shift from the US central bank. We had expected the US dollar to remain well bid but not to appreciate so fast. From a fund selection perspective, it was a very contrasted year. Some strategies performed very well and produced significant alpha, whereas others were large detractors, and a wide dispersion of performances was observed. The trend-following strategy, long/short equities and long/short credit, defensive equities, and European value provided the best contributions. On the other hand, small caps, growth stocks, long duration bonds, and Chinese equities detracted the most.

Our decision to increase the allocation to hedge funds, in 2021 already, proved helpful, both for the performance and for the volatility of portfolios. We continued to increase the exposure to hedge funds in 2022 and this was a valuable decision. The exposure to gold has also been beneficial, in terms of capital preservation and portfolio diversification.

Our caution on fixed income still proved to be too optimistic

Our fixed income allocation has been underweight for an extended period as we had reduced it by 9% in 2021 to boost the allocation to hedge funds. At the beginning of 2022, we did not like sovereign debt but were more constructive on credit due to the ongoing search for positive yield, favourable technical and strong corporate fundamentals. These factors were brushed aside, as credit spreads widened noticeably, and risk-free interest rates increased considerably. Markets stabilized somewhat since the summer, however, and the asset class is regaining the favour of investors, with investment grade credit considered the most attractive segment of the market.

Portfolio diversification was helpless in elevated asset correlation

There has been a lot of debate about the traditional structure of portfolios where the combination of bonds and equities should normally provide at least some kind of protection during periods of market stress. This was clearly challenged in 2022 as the drawdown of bonds was severe across all market segments, and their performances were often as bad as that of equities, leading to an above-average level of correlation. Cash, alternative assets, gold, and FX did contribute to alleviate some of these concerns over portfolio diversification, but we believe that the traditional asset classes will again be less correlated in the year ahead. With the ending of zero interest rates policies, there is a much better chance that this will be the case.

2022: ECONOMIC AND POLITICAL DEVELOPMENTS

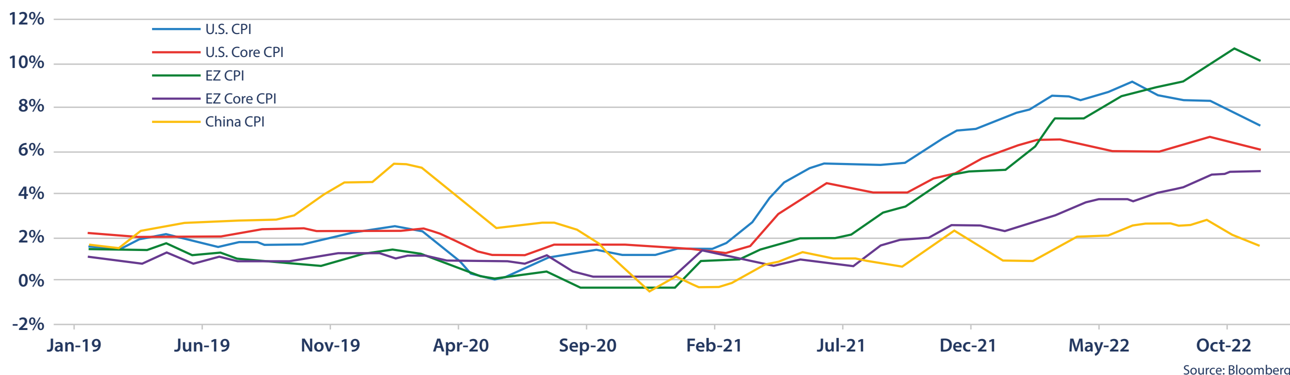
Ongoing economic challenges were aggravated by the war in Ukraine and China's COVID policy

The global economy slowed down much more than forecast in 2022. A fragile recovery in 2021 was followed by gloomy developments in the past year as downside risks materialized. Russia's invasion of Ukraine triggered a humanitarian crisis and contributed to a significant slowdown of growth by adding to ongoing fuel and food inflation pressures. It also aggravated pandemic-induced supply and trade disruptions and set off an energy crisis in Europe. The tightening of financial conditions due to the very restrictive monetary policies of the major central banks was much more pronounced than anticipated for the developed economies. Finally, a worse-than-expected slowdown in China, because of the country's zero-tolerance COVID policy, meant that growth projections for the country, and the surrounding region, turned out to be far too optimistic. All this led major institutions to consistently downgrade their growth forecasts for the global economy in 2022; the International Monetary Fund (IMF) and the World Bank both cut their January forecasts by 1.2% from 4.4% and 4.1% to 3.2% and 2.9% respectively, reflecting the fast-deteriorating outlook for economic activity.

Inflation pressures have been more entrenched than predicted

As in 2021, inflation was the hottest issue for the financial markets during the past year. The main central banks' initial belief that inflation would be transitory proved to be well off the mark. Inflation pressures continued to rise at a fast pace and reached levels not observed since the 1980s. Higher commodity prices and transport costs, supply disruptions at a time when demand for manufactured goods exploded, and rising wages all contributed to push inflation to very elevated levels. Pressures have started to recently abate thanks to positive base effects, lower commodity prices, a significant drop of shipping costs, and weaker demand for goods due to the negative shock on disposable income. The key question is not whether inflation will continue to decelerate but more at which level it will eventually stabilize.

Levels of inflation have started to decelerate



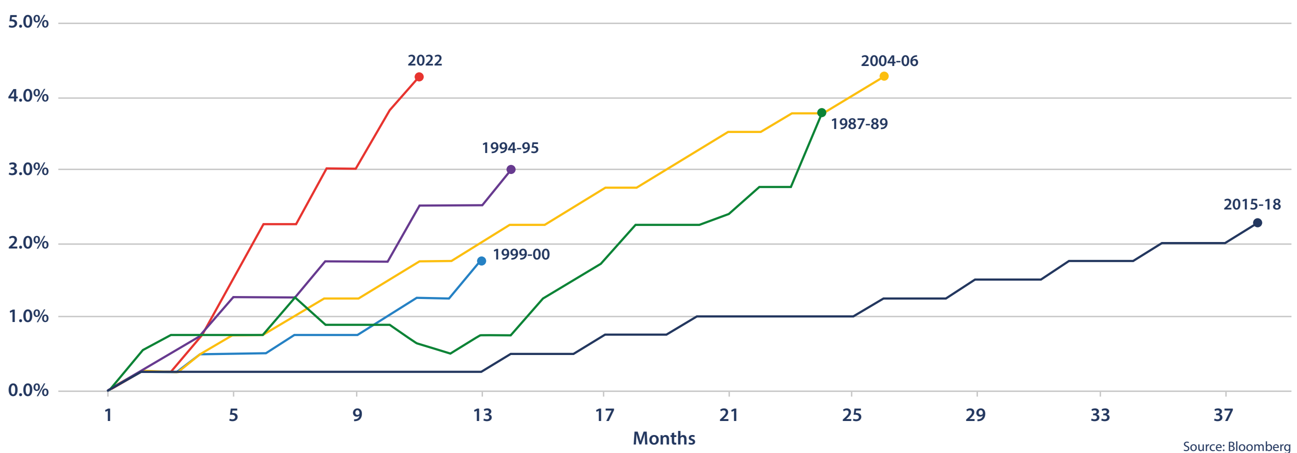
Source: Bloomberg

The chart shows that inflation continued to rise at a fast pace in both the US and the Eurozone during the first semester. Whereas inflation in the US started to decline from the summer onwards, the situation in the Eurozone was compounded by the worse impact of the war in Ukraine on energy and food prices, and by a weaker currency.

The unprecedented speed of the Federal Reserve's monetary policy tightening

2022 will be remembered as the year when the era of extremely accommodative monetary policies finally came to an end. Since the great financial crisis, the major central banks had lowered interest rates to zero, or even into negative territory. The Federal Reserve did attempt to normalize rates from 2015 onwards, admittedly, but it had to loosen them again in 2019, as the US economy slowed down. It then cut rates to zero at two urgent meetings when the COVID pandemic erupted in the first quarter of 2020. Following two years when rates remained unchanged, investors had been expecting some monetary tightening in 2022, through the combination of higher interest rates and a contraction of balance sheets, but they were not prepared for what followed next. Once the Fed recognized that their inflation forecasts had been totally wrong, its ensuing change of policy was so radical that it triggered a massive selloff across all segments of bond markets. The US central bank hiked its rates by 4.25% in 2022 to a range of 4.25% to 4.50%, with other central banks taking a similar path, even if not at the same pace. The latest interest rate decisions and communications from the main central banks have confirmed their hawkish stance and forced markets to adjust their expectations accordingly.

The change in fed funds rate since hiking began (% points)

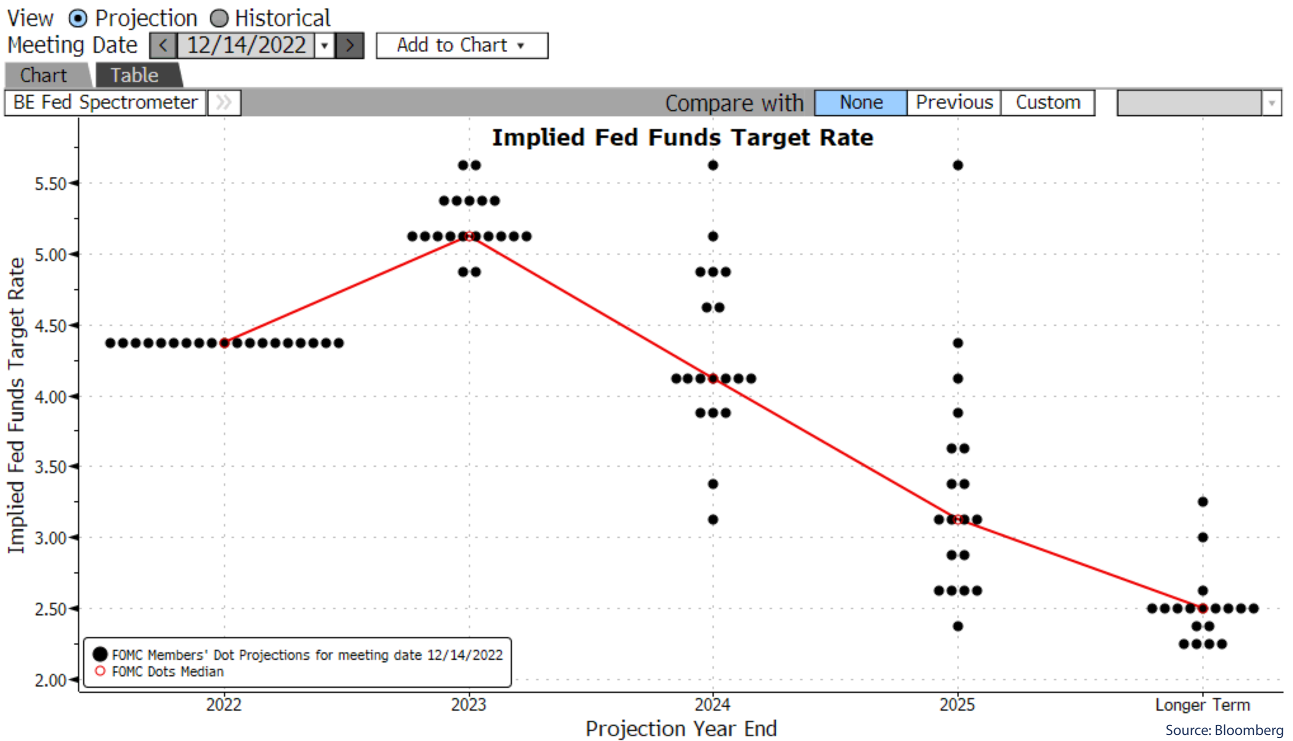


Source: Bloomberg

The chart shows that the speed at which the Federal Reserve tightened its policy in 2022 has been much faster than during previous periods of monetary tightening. The Fed's shift from a very accommodative monetary policy to a very restrictive one took place in a matter of months only, as the size of rate increases quickly rose from 0.25% in March to 0.75% at four consecutive FOMC meetings between June and November.

The central bank's objective was not only to fight inflation but also to regain market credibility as it had to recognize that it had made a big mistake by underestimating inflation risks. Investors had become so used to ultra-low or even negative interest rates that they had forgotten that rates could rise so fast, and the correction of bond markets was unprecedented.

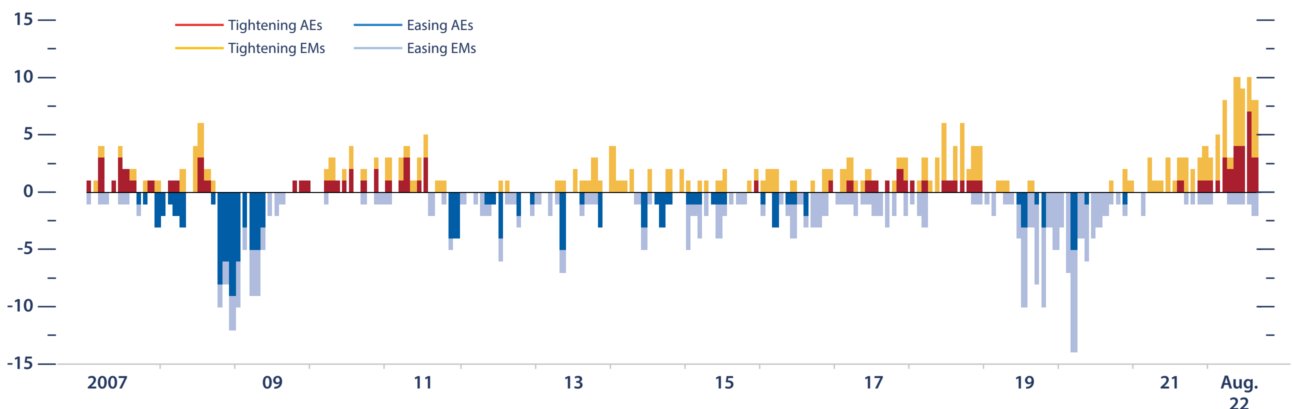
The Federal Reserve targets a higher for longer Fed fund rate



Source: Bloomberg

The Federal Reserve's so-called dot plot, which the U.S. central bank uses to signal its outlook for the path of interest rates, shows officials expect to raise the fed fund rate three times in 2023 to a 5% - 5.25% range, based on median projections. These projections also show that Fed officials do not anticipate rates to be cut in 2023 already, in contrast to markets' expectations for two 0.25% cuts. As a reminder of how dramatic the Fed's shift of policy was in the past year, Fed officials had projected in December 2021 only three rate hikes of 0.25% in 2022 to a range of 0.75% - 1% compared to the actual range of 4.25% - 4.50%!

Number of G20 central banks tightening vs. easing

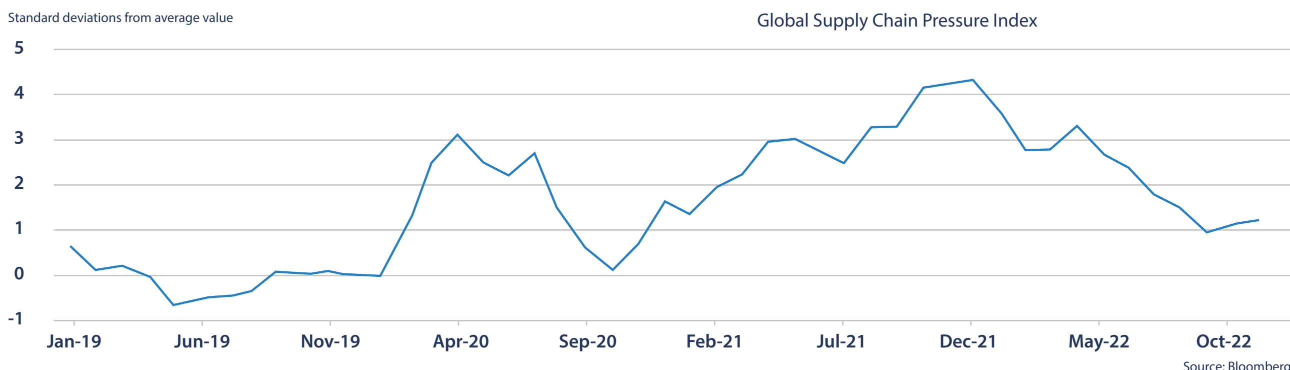


Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: AEs = advanced economies; EMs = emerging market economies.

The chart shows the seismic change in the monetary policy cycle among G20 economies in 2022 and the fact that it became increasingly synchronized around the world. With most central banks tightening their policy, it is interesting to note that some emerging market central banks managed to cut rates last year as they had acted sooner to contain inflation pressures.

The stress on global supply chains has eased

The level of stress on global supply chains has been easing for most of the past year even if it remains well above levels observed before the start of the COVID pandemic. At the beginning of the year, global supply chains saw their levels of stress decline from their December 2021 peak before intensifying again until April as coronavirus lockdown measures in China and the war in Ukraine lengthened delivery times. The ensuing improvement has mostly been due to a significant drop of shipping and air cargo costs, shorter delivery times, and much lower congestion levels at ports around the world. This trend also reflects a weakening demand for goods, with volumes of imported containers declining, as high inflation hurts purchasing power.



The chart shows that the New York Federal Reserve's Global Supply Chain Pressure Index is now down more than 75% from last December's record high, but it has not returned to pre-COVID levels yet. The index integrates transportation cost data and manufacturing indicators to provide a gauge of global supply chain conditions.

CONCLUSIONS

The main conclusion that we can draw from last year's economic and political developments is that the recovery of the global economy in 2022 fell well short of expectations. Ongoing inflation pressures were aggravated by Russia's invasion of Ukraine and proved to be much more persistent than anticipated. China did not manage to get its economy back on track, whereas the monetary policies of most central banks were far more aggressive than forecasted. All this has led to a cost-of-living crisis and a surge of concerns over energy supplies in Europe. Geopolitical tensions have also continued to rise, and the lack of in-depth diplomatic relations at a time when they are badly needed is a major concern for trade and investment. On the more positive side, inflation pressures have started to abate, labour markets have remained resilient and supply chain disruptions have declined significantly.

2022: THE FINANCIAL MARKETS

Investors will not remember 2022 with any kind of fondness as it proved to be a very brutal year for capital markets. Inflation pressures, the war in Ukraine, and the fast-paced tightening of monetary policies were the main drivers for the significant weakness of markets. In a risk-off environment, there was hardly anywhere to hide, and this was reflected by the dreadful performance of US Treasuries, widely considered to be amongst the safest of assets. Volatility in the bond markets reached crisis levels and remained very elevated for most of the year. This stress spilled over to the other asset classes, and the high level of correlation between equities and bonds meant that diversification failed to protect well against portfolio losses.

2022 PERFORMANCES

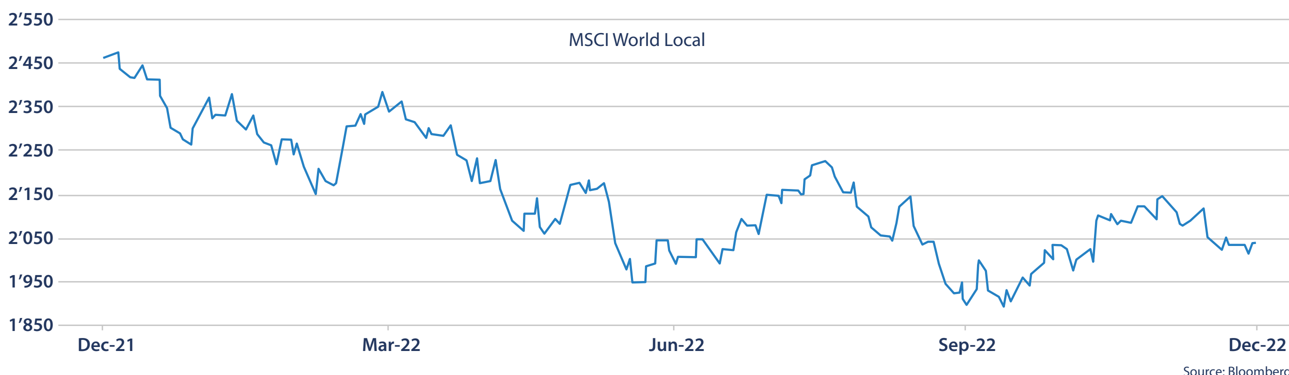
	End 2021	End 2022	2022 performance
EQUITIES			
S&P 500	4’766.2	3’839.5	- 19.4%
Euro Stoxx 50	4’298.4	3’793.6	- 11.7%
MSCI EM	1’232.0	956.4	- 22.4%
YIELDS			
UST 10-year	1.51%	3.88%	+ 237bps
Bund 10-year	- 0.18%	2.57%	+ 275bps
BBB EU	0.95%	4.42%	+ 347bps
CURRENCIES			
EUR/USD	1.137	1.071	- 5.8%
USD/CHF	0.913	0.925	+ 1.3%
GBP/USD	1.353	1.208	- 10.7%
USD/JPY	115.1	131.1	+ 13.9%
EUR/CHF	1.038	0.990	- 4.6%
COMMODITIES			
CRB Index	232.4	277.7	+ 19.5%
Oil, WTI	$ 75.2	$ 80.3	+ 6.8%
Gold	$ 1’829	$ 1’824	- 0.3%

Source: Bloomberg

EQUITIES

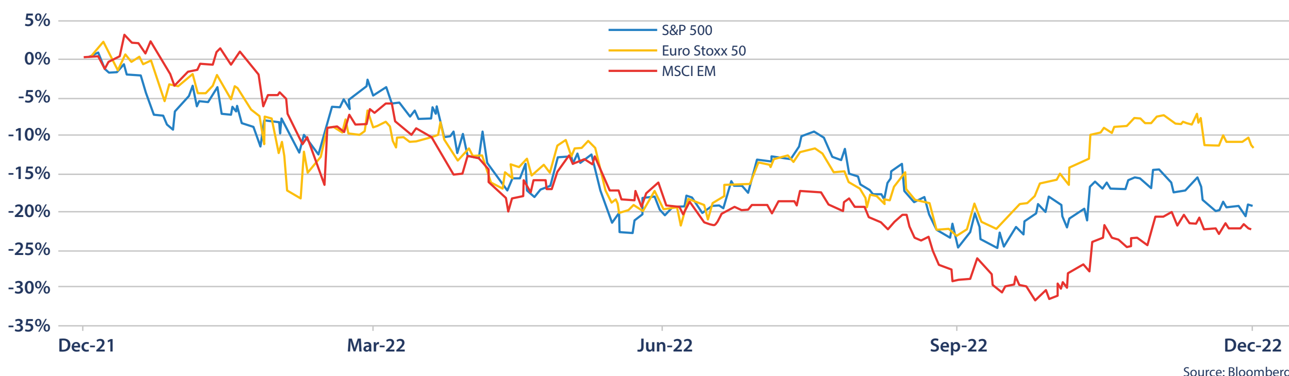
Equity markets were driven more by market sentiment and expectations relative to monetary policies than by company fundamentals in 2022. The derating of valuations, which had started in 2020, was extended, even if the corporate sector demonstrated a lot of resilience as most companies managed to pass on rising costs and to maintain their margins. The forward price-to-earnings ratio of global equities has effectively declined from around 18 times at the end of 2021 to around 15 times a year later, with US equities now valued at 16.6x their next twelve months estimated earnings, compared to 21.7x a year ago. 12-month forward P/Es of European and Japanese equities have dropped from 16.1x and 14.4x to 12.3x and 12.4x, respectively. In terms of investment style, value outperformed growth, while the best performing sectors were energy, consumer staples and healthcare, and the worst being technology, communication services and consumer discretionary.

The MSCI World Local Index



Global equity markets got off to a poor start in 2022 largely due to the increasingly hawkish tone of the Federal Reserve, but also in view of a lack of visibility on many key issues. Inflation pressures, the disruption of supply chains, the pandemic and the situation on the Ukrainian border were some of the strongest headwinds that equity markets had to contend with initially. The steep rise of bond yields was especially hurtful for growth stocks, and this remained the case for most of the year. Equity markets struggled to adjust to the accelerating pace of interest rate hikes by the Federal Reserve and to cope with the extreme volatility of bond markets. The bear market for equities was interrupted by several intermediary rallies, however, thanks in part to the reporting of solid corporate earnings, but also because long-term bond yields did decline during some periods. This trend of lower long-term yields was observed in June, July and from the end of October, contributing to the better behaviour of equities during those months. It must also be noted that market sentiment had become extremely depressed, with positioning being very defensive, and these factors contributed to the rebound of markets during the last quarter.

S&P 500 – Euro Stoxx 50 – MSCI Emerging Markets



As shown in the chart above, the Euro Stoxx 50 Index finally outperformed the S&P 500 and MSCI EM indexes in 2022, despite its more severe drawdown observed in the first quarter. The Euro Stoxx's much lower exposure to the IT sector was one of the reasons for this outperformance, as was the weak performance of the US mega-caps. Alphabet, Amazon, Tesla, and Meta were amongst the S&P's worst detractors, with losses ranging from 39% to 65%, and other giants such as Apple and Microsoft dropped by more than 26%. Emerging markets had a very bumpy ride because of the volatility of Chinese equities but ended the year on a strong note to close the gap.

COMMODITIES

The Refinitiv/CoreCommodity CRB Index

The Refinitiv/Core Commodity Index gained 19.5% in 2022 but ended well off its intra-year peak observed in June already. Commodity prices rose quickly at the beginning of the year as inflation pressures mounted and on anticipation of fully reopening economies. The prices of energy and industrial metals climbed the most before the eruption of the war in Ukraine triggered an acceleration of the ongoing trends. Higher-than-average financial speculation compounded these price rises until early-June when a significant reversal took place.

It was a rollercoaster year for oil prices. An early-year positive trend was followed by a spike of prices due to the war in Ukraine, raising concerns over supply. As markets gradually realized that these supply concerns might have been exaggerated, oil prices started to slide. This trend was exacerbated by the slowdown of economic activity in China due to strict zero-COVID restrictions. Concerns over weaker demand led OPEC+ countries to cut production by 2 million barrels in October, but this has not stopped oil prices from ending 2022 only a little above end-2021 levels.

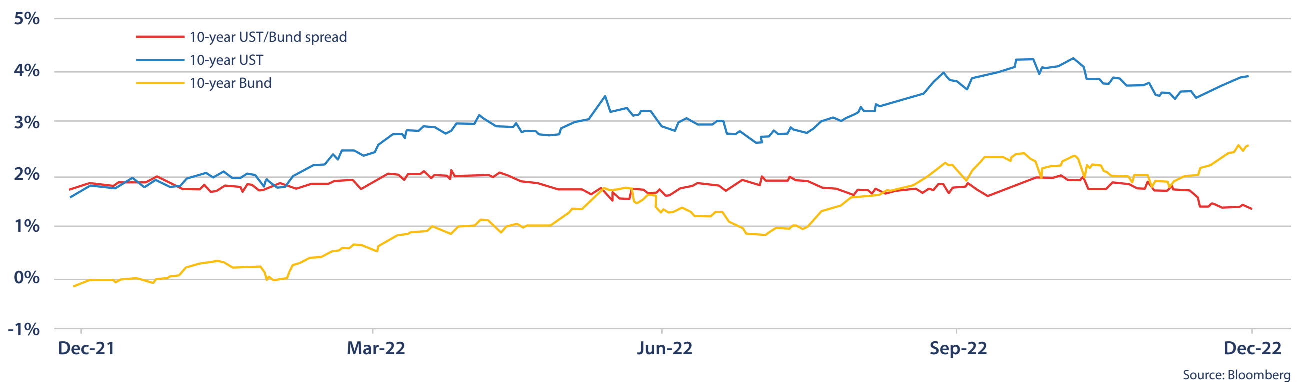
Gold

2022 was also a bumpy year for gold. Gold prices spiked in early March, in US dollar terms, as investors took refuge in the precious metal in a risk-off environment. The price of an ounce rose by 13% to reach $ 2'070 before falling gradually to an early-November low of $ 1'616 due to higher real interest rates and a stronger US dollar. From then on, gold prices recovered all of the yearly losses as these yield and dollar headwinds reversed, and as central banks in emerging countries were active buyers.

DEBT INSTRUMENTS

The rise of government bond yields was an entrenched trend for most of 2022 because of central banks fighting inflation pressures by implementing very restrictive monetary policies. The Federal Reserve started its hiking cycle by increasing rates in March by 25bps, but quickly changed gears, with a 50bps rise in May, and then four jumbo hikes of 75bps up to November. The final FOMC meeting of 2022 produced a 50bps move as the Fed gradually returns to a more traditional hiking cycle for 2023. The ECB started to increase rates later but also raised them twice by both 50bps and 75bps. These aggressive policies triggered elevated volatility in bond markets, as investors struggled to keep up with these big moves. 10-year Treasury yields thus climbed from an end-2021 level of 0.92% to 4.24% at the end of October before declining and ending the year at 3.88%. The most noticeable trend has been the inversion of the US yield curve; its 2-year yield ended the year 54bps above the 10-year one, usually signalling an upcoming recession.

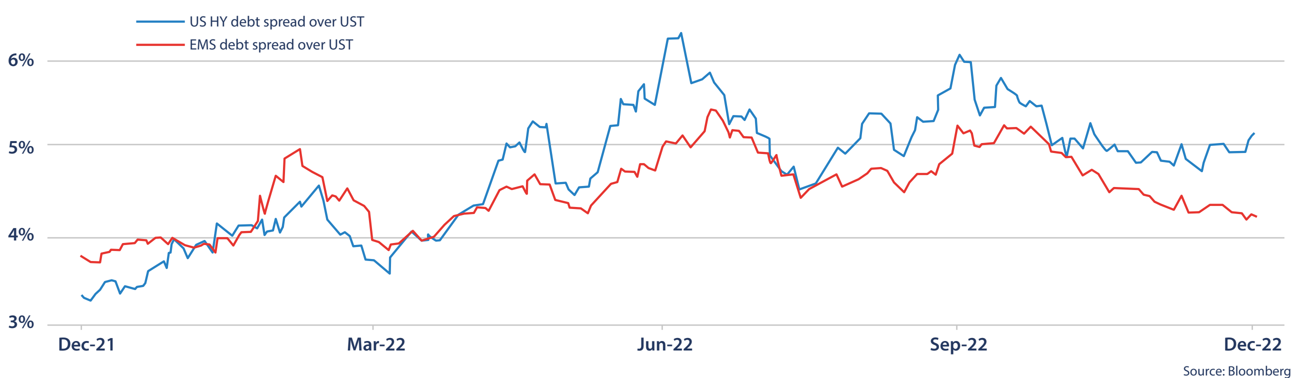
10-year U.S. and German government bond yields and spread



Source: Bloomberg

The chart shows the highly correlated behaviour of 10-year Treasuries and Bunds for most of the year. Even though the Federal Reserve began its aggressive tightening cycle much sooner than the ECB, the 10-year spread between Treasuries and Bunds remained largely within a 1.5% to 1.9% range. More recently, the spread has narrowed as Bund yields continued to rise, in contrast to those of Treasuries, as they priced in higher interest rates by the ECB than previously expected.

Emerging Market Debt and U.S. High Yield spreads



Source: Bloomberg

The spread of emerging market debt widened at a fast pace until early-March, largely due to the beginning of the war in Ukraine, before contracting rapidly. Since then, the EM debt spread was very much in sync with that of high yield spreads, as both were mostly driven by monetary policy considerations and market sentiment.

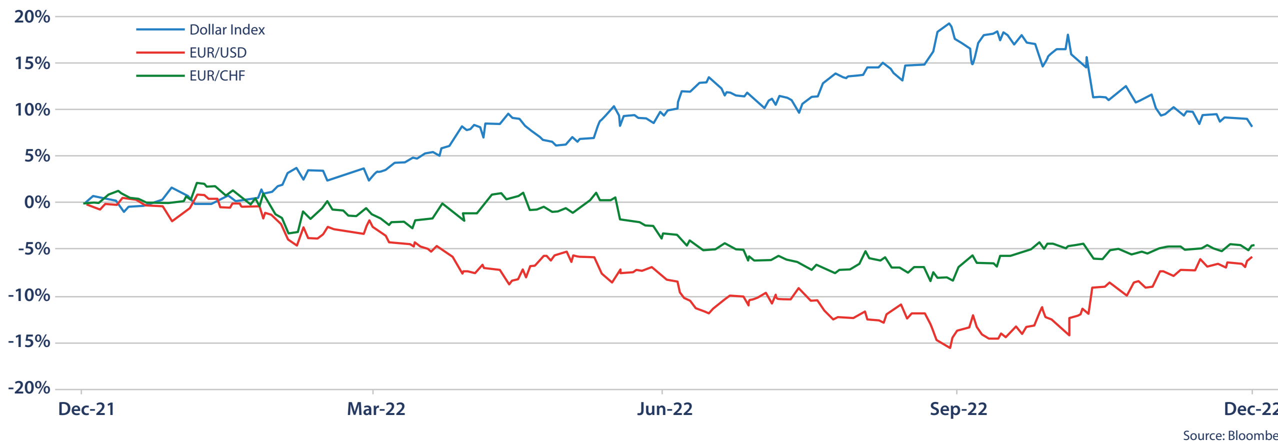
Debt instruments' market performance in 2022 (USD)

World Government Bond Index Local	- 13.8%
Euro Broad Investment Grade Index	- 17.2%
U.S. Credit AAA	- 10.1%
U.S. Credit BBB	- 15.9%
Global Emerging Market Sovereign	- 18.2%
U.S. High Yield	- 11.0%

Source: Bloomberg

CURRENCIES

The main trend observed in the currency markets in 2022 was the appreciation of the US dollar against most other currencies, as was already the case in 2021. The greenback benefited massively from the Federal Reserve's fast tightening of its monetary policy, of course, but it was also supported by the strong demand for haven assets, and a more favourable terms-of-trade for the US caused by the energy crisis. Other major currencies, including the euro, the pound, and the yen all had their own specific issues, and depreciated consistently until the fourth quarter. The Brazilian real and the Mexican peso were amongst some of the rare major currencies that appreciated against the greenback, whereas the Singapore dollar and the Swiss franc were barely changed. The worst performers, within the major crosses, were the Japanese yen, the Swedish krona, the Norwegian krone, the British pound, and the Taiwanese dollar.



Source: Bloomberg

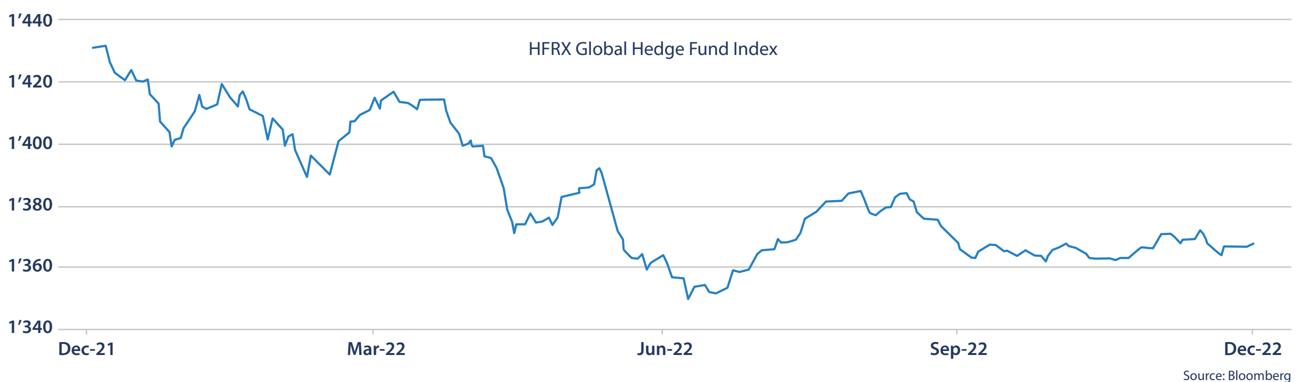
The chart shows that the dollar index trended higher for most of the year before retreating during the fourth quarter as investors took the view that the main central banks were edging closer to peak rates. Investor sentiment had also reached extreme lows, and the dollar was one of the main losers during a period when the appetite for risk returned. It was not only the case of dollar strength. The euro was badly hurt by fast rising import costs for energy, the British pound was temporarily hit by poorly thought political decisions, and the yen depreciated in view of the BOJ's ongoing accommodative monetary policy. The result of these movements is that the appreciation of the dollar means that it is now heavily overvalued, and at risk of entering a period of correction at some stage in the year ahead.

HEDGE FUNDS

2022 was a mixed year for hedge fund managers as some strategies were able to benefit from inflation-related trades whereas others struggled to adapt to the ending of cheap money. Many of the best opportunities have materialized on the short side of fixed-income and some quant firms have generated strong returns through their systematic strategies. Macro multi-strategy funds have also fared well, while a high level of dispersion has been observed in the long/short equity space.

According to Preqin data, the $4 trillion hedge fund industry suffered from $75 billion of net outflows in 2022 through October, and that number may have increased by the end of the year as investors rebalanced their portfolios. Equity-focused hedge funds suffered the most from outflows as stock pickers had a tough year and failed to protect sufficiently against selloffs; roughly 42% of the hedge funds liquidating through September were equity-focused ones. The growth of the hedge fund industry also appears to have stagnated; 2022 is on track to have seen the least number of hedge fund start-ups globally since Preqin started compiling the data in 2000. In theory, 2023 should present favourable conditions for hedge funds. Higher interest rates, more volatility, and a return to fundamentals should be supportive factors for hedge fund strategies.

The HFRX Global Hedge Fund Index



Source: Bloomberg

Hedge Fund strategies' performances in 2022 (*end November)

Index	Performance
HFRX Global Hedge Fund Index	- 4.4%
HFRX RV FI Convertible Arbitrage Index	- 12.5%
HFRX Multi-Emerging Markets Index	- 7.9%*
HFRX RV FI Corporate Index	- 7.4%*
HFRX Equity Hedge Index	- 3.2%
HFRX Macro Multi-Strategy Index	+ 3.9%*
HFRX Event Driven Index	- 7.3%
HFRX Equity Hedge Short Bias Index	+ 3.6%*
HFRX Macro Systematic Diversified CTA Index	+ 16.9%

Source: Bloomberg

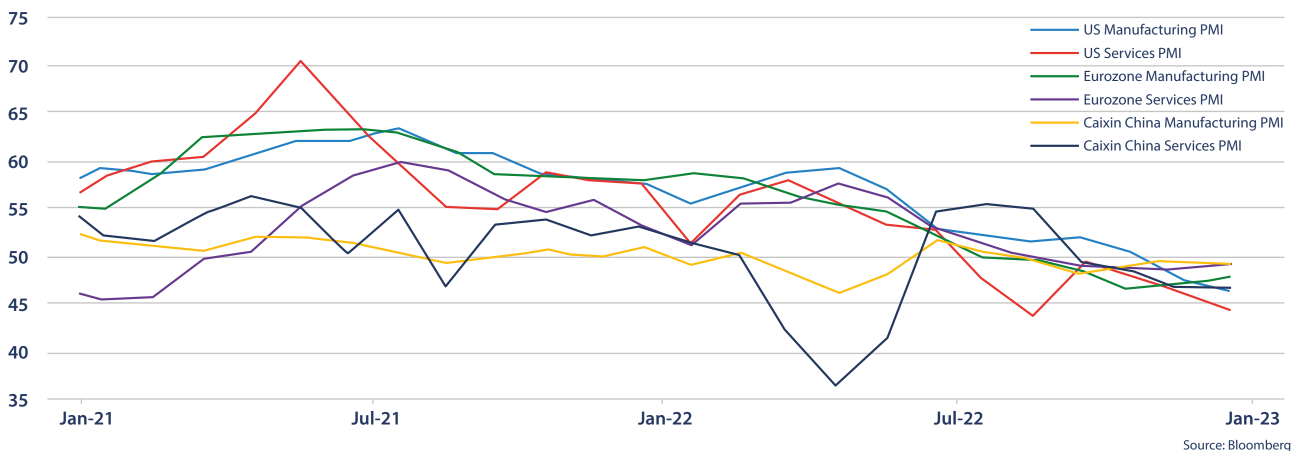
2023: ECONOMIC OUTLOOK

A slowdown in global GDP growth will continue in 2023

The global economic outlook has continued to deteriorate, and global GDP growth is expected to slow in 2023. There is also a significant risk of the world sliding into recession with growth expectations for the United States and Europe being either very low or negative. Much will depend on the pace of deceleration for inflation and the trajectory of interest rate increases. The task of central banks around the world is extremely challenging as they still need to raise interest rates further to bring inflation back to more supportable levels at a time of slowing economic growth. This means that they risk pushing economies into recession, especially if labour markets were to weaken and consumers to become less willing to spend. The risks relative to the energy crisis in Europe have abated for the time being but the prospect of energy shortages remains an ongoing threat. On a more optimistic note, economic prospects could pick up if China finally managed to reopen successfully, and if a peaceful resolution could be reached between Russia and Ukraine even if this scenario appears as very remote at the time of writing.

In its October 2022 report the IMF estimates that global GDP will slow to 2.7% in 2023, and the Bloomberg Contributor Composite indicates that World GDP growth will be 2.1% only. From a regional perspective, this same Bloomberg Composite anticipates GDP growth of around 0.3% in the US, 4.9% in China and a 0.1% contraction in the Eurozone, with the probability of a recession in the US estimated at 65%, and at 80% for the Eurozone.

Leading indicators: Purchasing Manager Indexes



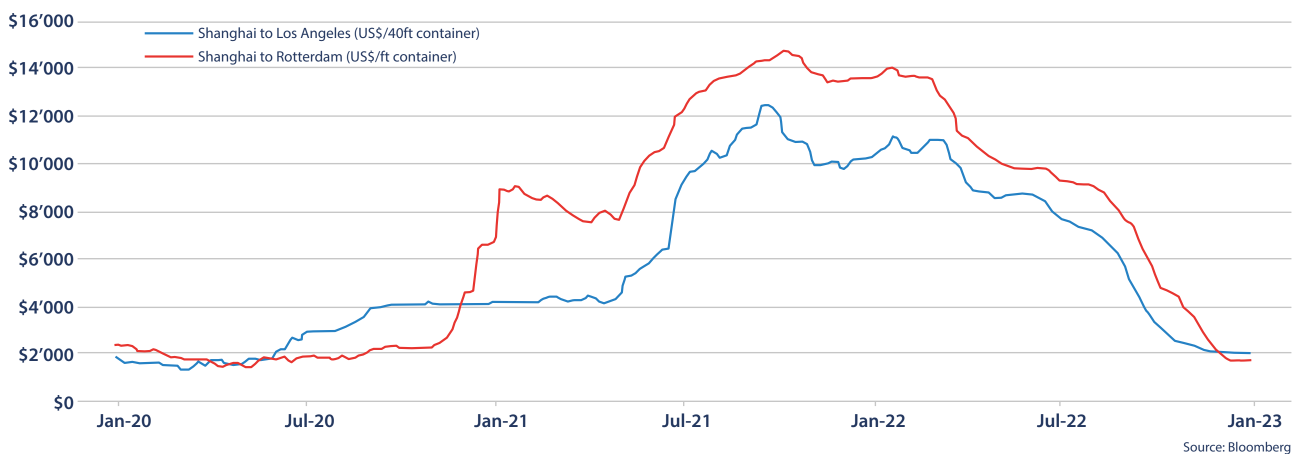
Source: Bloomberg

The chart above shows that PMI Indexes are in contraction territory (readings below 50) as global economic activity continues to slow. The Chinese Caixin Manufacturing index has spent most of the year below 50, because of manufacturing having been constrained by coronavirus lockdown measures. One can observe a similar trend for US and Eurozone PMI indices which have decelerated at a fast pace from the second quarter onwards. This reflects an increased risk of recession due to the cost-of-living crisis, tighter financial conditions, and an elevated aversion to risk in response to growing economic gloom.

A full reopening of China's economy would remove some uncertainty

The frequent lockdowns that took place in China in 2022 under its strict zero COVID policy took a heavy toll on its economy. The IMF is projecting that 2022 GDP growth will be 3.2% only compared to early-year projections of 5%. Given the size of China's economy and its importance for global supply chains, this weaker than anticipated level of economic activity has been a major headwind for the global economy. The ongoing weakness of the property sector, which represents about one-fifth of its economy, was another drag on GDP growth. Chinese authorities have taken a set of measures to support the property sector and their recent decision to abruptly abandon its zero-COVID policy offers some hope that the Chinese economy will finally be able to fully reopen in 2023. In the meantime, this U-turn has triggered massive coronavirus outbreaks, with voluntary social distancing slowing activity down again. This means that the country still has a long way to go before returning to a pre-pandemic normal, but a full reopening of China would help to counter some of the economic weakness forecasted for other major economies.

Shipping costs have declined significantly



Source: Bloomberg

Extremely high logistics costs were one of the contributors to inflation during the pandemic. But since the spring of 2022, shipping costs have dropped noticeably as shown in the chart above. Rates to ship a 40-feet long container from Asia to the US and Europe have come down by more than 75% since the end of April, close to pre-pandemic levels, with shipping delays having also dropped quickly. This has been driven largely by a drop of consumer spending, which had been responsible for increased sales among many importers over the last two years. From an inflation viewpoint, the fall of shipping costs is obviously welcome but there is a significant risk that the slowdown in demand could push the economy into a recession.

Inflation will decline…but how fast?

Inflation will remain the main issue for financial markets in 2023 as it will continue to drive the monetary policy of the central banks as well as wage demands. It is widely accepted that inflation in the US and the Eurozone has almost certainly peaked, but the same cannot be said with certainty for inflationary pressures. Inflation has started to decline but remains well above the central banks' target levels as it is still in double digits in the Eurozone and UK, and at 7.1% in the US. It is also striking that US CPI ex-food and energy data has not dropped since the beginning of 2022 and was still at 6% in November. The anticipated drop in inflation will be driven by favourable base effects, including lower commodity prices and easing supply chain pressures, but there is a risk that inflation could remain higher than forecast. With low unemployment rates, wage demands are unlikely to moderate in the months ahead. Furthermore, the shelter component accounts for a third of US CPI and it reacts with a significant lag to a drop of home price changes, so it could stay elevated for several months. All this explains why central banks will raise interest rates further despite a slowing economy and moderating inflation. Their recent communication also shows that they are prepared to take the risk of over-tightening rather than pause their hiking cycle prematurely.

Geopolitical risks remain but US political risk has diminished

Geopolitical risks remain a major concern for financial markets. There are many sources of tensions across the world and diplomatic relations are at a low point. Russia is trying to strengthen ties with China and Iran and to weaken the Western alliance, while tensions between China and the United States over Taiwan and the supply of semiconductors are unlikely to subside in the near term. North Korea, the Balkans, and Iran are some other regions where geopolitical risks also represent a serious threat.

The US mid-term elections did not produce the largely anticipated results, as the Republicans failed to win both the House and the Senate. As expected, Republicans did seize control of the House of Representatives, but by a much smaller-than-expected margin, whereas the Democrats retained control of the Senate. This means that the political process will mostly be in gridlock with little chance of any major legislation being voted in the next two years, and markets have historically preferred that sort of predictability.

Conclusions

Consensus expectations are for the global economy to slow in 2023 and there is also a significant risk of the world sliding into recession. The main central banks face a daunting task of balancing their fight against inflation at a time when economic growth is very weak, and the risks of a damaging policy mistake are higher than average.

We expect inflation pressures to continue to decline but it is most unlikely that inflation will drop back close to the target levels of the central banks. Fading base effects are a given, but other factors are more difficult to predict, wage inflation being the main one.

As always, political, and geopolitical risks are wild cards for financial markets. Geopolitical risks remain high, but one cannot exclude the possibility of some unexpected positive developments. Some political risks appear to have decreased following elections in France, Brazil, and in the US.

2023: FINANCIAL MARKETS' OUTLOOK

A better starting point for portfolio returns

Compared to a year ago, portfolios should benefit from a much better valuation starting point for future returns. The valuations of equities have continued to derate, bonds are once again offering positive yields, and some of the distortions and excesses of the previous years have been erased. This means that fundamentals are likely to matter more now that the era of easy money has come to an end, and the assumptions over long-term returns have improved noticeably. This does not mean, however, that 2023 can only be a positive year for the portfolios. Uncertainty is prevalent on many issues and the equity asset class still faces headwinds. That largely explains why we have maintained our overweight allocation to alternative strategies and have increased our fixed income exposure recently.

Markets continue to face tighter monetary policy and high levels of uncertainty

Concerns around inflation and the monetary policies of the main central banks have driven markets in 2022 and will continue to do so in the months ahead. While investors will no longer have to face the same pace of interest rates increases, there remain unanswered questions over the terminal levels of these rates and when they could begin to be cut. We do not share the optimism of markets that the Federal Reserve will already cut rates in 2023, and a few good prints of lower-than-expected inflation data does not mean that the threat of inflation will go away quickly. Another concern relates to companies' earnings which remained surprisingly resilient in the past year, but which could disappoint in the quarters ahead.

DEBT INSTRUMENTS' OUTLOOK

A transformed landscape for the asset class

2022 was one of the worst years ever for bond markets, largely due to the breath-taking pace of monetary tightening. However, this means that market conditions have improved significantly for fixed income assets, because of much higher risk-free yields and wider credit spreads. It is also possible that peak long-term yields might have already been reached, so duration risks are much lower than a year ago. All this contributes to the better risk/return profile of the asset class.

High quality corporate credit offers an attractive risk/return

Investment-grade credit is attractive once again. Investors should be well compensated for credit risks in view of the wider spreads, solid balance sheets, and abating deep recession concerns. Corporate fundamentals also remain strong so the risk of default for high quality issuers appears as low. For high-yield bonds, the picture is a little different as credit spreads have tightened markedly in the past months, and a better entry point might emerge in the months ahead.

Emerging market debt has the potential to outperform

It was a tough year for emerging market debt, but the asset class appears to have turned the corner. A better outlook for the Chinese property sector, attractive yields, and the potential for a weaker US dollar could all provide to be supportive factors in 2023.

EQUITY OUTLOOK

Equities are no longer the asset of choice

A lot has changed in the capital markets over the past year and equities appear to have lost their longstanding status as the asset of choice. As interest rates have risen at a very fast pace, bonds have become increasingly attractive relative to equities, and this has resulted in flows returning to fixed income assets, and to investment grade credit primarily. Hedge funds have also returned to the fore in investors' minds and should continue to attract capital. All this means that portfolios are less likely to hold comparable overweight allocations of equities as in the previous years, and that it should be easier to build more diversified portfolios.

Valuations are attractive in many regions

The recent rally of equities means that their valuations have been rising again but remain generally attractive, except those of US equities which are back above their long-term average. From a long-term perspective, the valuations of European, UK, Japanese and emerging market equities are appealing, and were the peak of the US dollar to be confirmed in the coming months, flows could favour international equities over US ones. We do not consider the current market conditions to be favourable to any major upgrade of their valuations.

Equity performance will largely depend on the path of earnings

The path of earnings should remain the main driver of equity performance in 2023. Earnings have been very resilient over the past years as companies were mostly able to pass on higher costs and to maintain their profit margins. There is, however, the risk that current consensus earnings could prove to be too high even if analysts have been revising them downwards since the middle of 2022. Margins could be squeezed by wage pressures, and weaker demand in the case of a deeper than expected recession. Equities are also at risk of excessive market optimism as they are pricing in several rate cuts by the Federal Reserve in the second half of 2023 already.

ALTERNATIVES

Hedge funds should continue to benefit from market dispersion

We are positive on the conditions for hedge funds and intend to maintain our above-average exposure to this asset class. High market dispersion, higher interest rates, and the probability that volatility will remain elevated, are all supportive factors for alternative strategies. Hedge funds will also continue to play a key role in terms of portfolio diversification.

Structured products will continue to benefit from periods of high volatility

In the prevailing market conditions, structured products will enable to further diversify portfolios and to reduce volatility by investing in a more defensive manner. With risk-free yields having increased markedly, some structures are of interest again, such as participation and capital-protected products. As always, the timing of these investments is crucial.

GOLD OUTLOOK

Gold is expensive but remains a source of diversification

Gold prices performed well in 2022 compared to most assets, despite the appreciation of the US dollar and the rise of real interest rates. This means that gold appears as being relatively expensive, but the precious metal has been supported by purchases by central banks in emerging markets and by its role as a defensive asset. We continue to consider gold to be a strategic asset, due to its role in terms of portfolio diversification and as a store of value. Gold is also a hedge against the more extreme risks.

Gold could be supported by shifting trends

On top of being a hedge against geopolitical risks, gold is increasingly seen by some countries as an appealing alternative to dollar reserves, especially following the freezing of Russian dollar ones. Combined with a potential correction of the US dollar in the quarters ahead, this factor could prove to be structurally supportive for gold prices.

CURRENCY OUTLOOK

The US dollar is likely to depreciate in the year ahead

In the near term, we expect the US dollar to regain some strength following its depreciation in the last quarter of 2022. Investors' long positioning on the dollar had become quite extreme and the markets' expectations that the Federal Reserve was getting closer to ending its hiking cycle triggered dollar weakness. We still believe markets are too optimistic on the prospects for Fed rate cuts in 2023. The central bank is also more likely to take the risk of overtightening than pausing too early and then having to tighten again. That is why we think that the dollar has the potential to appreciate in the short term before entering a period of correction.

The euro could benefit from a full reopening of China

We do not believe that the euro will appreciate much more in the near term against the dollar as the common currency has benefited from some support that is likely to wane. A more hawkish Fed than expected by the markets, risks of higher energy prices, and a deteriorating trade balance are some headwinds that could prevent the euro from adding much to its recent gains. Further ahead, the EUR/USD parity could enter a more sustained positive trend. The dollar is very overvalued, the full reopening of the Chinese economy should benefit the Eurozone more and the Fed would likely cut rates faster in case of a worse-than-expected recession in the US.

The Swiss franc should remain well bid

We expect demand for the Swiss franc to remain solid in 2023 as the currency will continue to be supported by its safe haven status, low inflation dynamics and stable public finances.
The shift of the Swiss National Bank's policy towards more tolerance of currency appreciation to limit inflation pressures is another supportive factor. The Swiss franc should also be one of the main beneficiaries from the likely upcoming correction of the US dollar.

2023: ASSET ALLOCATION

CASH (5%)

Our allocation to cash is neutral

The allocation to cash has been reduced to neutral recently. The cash exposure moved from an early-year underweight position to overweight after we had reduced some portfolio risk by cutting some equity positions following the summer rally.

DEBT INSTRUMENTS (32%)

Our allocation to fixed-income assets is modestly underweight

Compared to a year ago, our global fixed-income allocation has been increased by 5% to the current level of 32%, which represents a modest underweight. We have added to some of our investment-grade funds as well to a more opportunistic credit strategy. It has been a long time since we could genuinely affirm that investment-grade fixed income was attractive but that is the case once again. The exposure to investment-grade bonds remains underweight, nevertheless, and includes corporate and sovereign debt as well as two unconstrained bond funds. Our exposure to debt instruments also includes high-yield credit in developed and emerging markets, convertible bonds, as well as European secured senior loans. We would expect the overall low duration risk of the fixed-income allocation to gradually increase in the year ahead.

An improved environment for fixed income assets

The past year has seen a seismic change of the environment for fixed income assets due to the radical shift in the major central banks' monetary policies. Risk-free yields have risen considerably, and credit spreads have also widened, leaving investors in a much better position to benefit from the core of fixed income investing, carry. We prefer to wait before increasing our allocation to high-yield bonds as renewed spread widening could be triggered by deteriorating recession concerns and from the risk of disappointing earnings. In the best-case scenario, emerging market bonds could outperform, from a starting point of above-average yields, a US dollar which appears to be tipping over, and an improving outlook for the Chinese economy.

EQUITIES (41%)

The allocation to equities is underweight and diversified

The portfolios have an underweight allocation to equities. The exposure to the asset class was reduced in different stages last year, including a rebalancing towards more defensive strategies from higher beta ones. Our expectations for the performance of equities in the year ahead are conservative as we are concerned that earnings' forecasts might prove to be too high, in view of the economic slowdown and the risk to the profit margins. The valuations of equities across many regions are below long-term averages, but not in the United States. Equity returns will be primarily driven by earnings as we do not anticipate valuations to rise much in the current context. We have maintained a diversified portfolio allocation across regions, investment styles, sectors, themes, and market cap sizes.

We still favour a more defensive equity positioning

It has been a tough year for many of the portfolios' equity strategies, but some have also fared very well in challenging market conditions. US growth small caps, the multi-thematic fund, as well as the technology one, have been the biggest detractors, whereas European value, high-dividend focused equities, and the metal mining fund have outperformed. All these strategies continue to figure in our portfolios as we believe that diversification is key. We continue to like defensive sectors, such as healthcare and infrastructure, and think that the European value fund's exposure to energy and financials also makes a lot of sense. At this stage, many funds benefit from very low valuation metrics so their risk/return profile appears promising, at least over the medium to longer term. We include emerging markets' equities in this category and believe that they offer significant catch-up potential, with much discounted valuations relative to US ones.

COMMODITIES (0%)

Our allocation to commodities is neutral

We do not hold any direct investments into commodities.

GOLD (3%)

Our allocation to gold is neutral

We have a 3% exposure to gold. Gold has held up remarkably well through 2022 in view of the rise of real interest rates and the appreciation of the dollar. This means that the current valuation can be considered as rich, but we continue to view gold primarily as a portfolio diversifier and as a hedge against several risks. A peaking US dollar and a pause of the Federal Reserve's hiking policy would represent potential supports for the precious metal.

ALTERNATIVES (19%)

The allocation to hedge funds is overweight

Our allocation to hedge funds has remained overweight through 2022 and this is also likely to be the case in the year ahead. The various hedge funds in the portfolios have behaved mostly as expected, by preserving capital, reducing portfolio volatility, and presenting very limited correlation with traditional assets. We continue to favour market neutral strategies, including long/short equities, long/short credit, and the event-driven strategy. We believe that hedge funds will benefit from the current market environment, where above-average levels of performance dispersion are observed across the different asset classes.

Structured products will continue to provide portfolio diversification

We remain opportunistic in our allocation to attractive structured products. Our focus has been to capture above-average levels of volatility and to target products offering income with a limited level of risk. We also look for solutions which offer some protection for the equity exposures.

FFG PORTFOLIO CONSTRUCTION

The construction of an investment portfolio and the selection of its individual components are the result of a well-defined investment process. This process begins with the determination of the client's risk profile, base currency, and the chosen investment strategy. This framework will then lead to the tactical positioning of the portfolio within strategic asset allocation ranges for each asset class.

The choice of the base currency is of particular importance as it will affect the way the investment strategy is carried out; firstly, through the determination of the most appropriate level of hedging of currency exposures (if any) and then, by the selection of the best-suited underlying investments.

The determination of the allocation to the different asset classes is the main driver of the portfolio's performance and serves as the keystone around which the other investment decisions are taken. The role of your investment manager at the Forum Finance Group is to build portfolios based upon all the relevant information and through the selection of investment products from a pre-determined approved investment universe.

Each individual investment has a specific role to play, and the selection of any product is based on both its inherent features as well as its complementary properties within the portfolio. It is necessary to fully understand each investment product to be able to predict to a large extent its behaviour depending on different market scenarios and to better evaluate its purpose in relation to the other assets.

Therefore, the performance of any specific investment should not be measured against its peer group without taking into consideration the remainder of the portfolio. Typically, the portfolios' risk budget will be spread across directional assets such as equities, commodities, and high-yielding debt. The portion of the portfolios dedicated to the preservation of capital will be invested into assets less correlated to market trends, such as hedge funds, highly rated bonds, and certain structured products.

HEDGE FUNDS

The Forum Finance Group invests into Funds of Hedge Funds and, for the clients that have approved this asset class in their mandates, into Single Hedge Funds.

Funds of Hedge Funds offer diversification and low volatility, while Single Hedge Funds focus on specialist strategies with an emphasis on risk management. We consider Single Hedge Funds to be genuine alternatives to the traditional asset classes, providing access to outstanding fund managers and improving the risk-return profile of portfolios.

After much internal discussion, we have decided to reclassify the long/short equity funds by moving them from the equity asset class into the alternative investments' allocation.
This change responds to the need for standardisation and simplification, and we have concluded that the type of strategy matters more, in terms of classification, than just the underlying assets.

STRUCTURED PRODUCTS

From our point of view, structured products provide an alternative way of investing into traditional asset classes such as equities, debt instruments and commodities. The different structures of these products vary considerably, and the selection of a specific structure is not only a function of the prevailing market conditions and the outlook for the underlying asset, but also a function of the capacity of the product to mitigate risk within the portfolio.

Structured products are classified within the most relevant asset classes at any defined moment. This allows us to better analyse the overall levels of risk of each asset class than if structured products were classified separately. Structured products are, by nature, hybrid instruments and the evolution of their different components will determine whether it becomes necessary to reclassify any structured product into a different asset class.

ASSET ALLOCATION GRID 2023

For our balanced accounts, we apply the following grid:

	ALLOCATION	JANUARY 2023
SHORT-TERM DEPOSITS	**0 – 20%**	**5%**
DEBT INSTRUMENTS	**15 – 55%**	**32%**
Investment grade bonds	5 – 45%	10%
EM & high-yield bonds	0 – 20%	12%
Specialist bonds	0 – 15%	10%
EQUITIES	**20 – 60%**	**41%**
Developed markets	15 – 50%	32%
Emerging markets	5 – 30%	9%
COMMODITIES	**0 – 15%**	**3%**
Physical gold	0 – 5%	3%
Other commodities	0 – 10%	0%
ALTERNATIVE INVESTMENTS	**0 – 25%**	**19%**
Hedge funds	0 – 25%	19%
Other	0 – 10%	0%
		100%

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