

EXECUTIVE SUMMARY

- **Financial markets experienced a perfect storm in 2022** — equities declined as earnings expectations and valuations adjusted to tighter monetary policy and slower growth, while bonds suffered a similar fate.
- **The economic cycle has been highly disrupted over the past three years** — several different investing environments have varying likelihoods of playing out over the next 12–24 months. A robust investment strategy must cater for more than one outcome.
- **US recession is widely expected** — we believe a soft landing, characterised by growth slowing but avoiding a ‘broad-based weakening’, is fairly likely, yet under-appreciated. In addition, the longer term US growth picture is increasingly supported by new structural drivers.
- **The intention to end zero-covid policy in China is a positive development, yet highly uncertain** — this justifies a meaningful valuation discount for Chinese markets, which is unlikely to dissipate in the short term.
- **European and UK recessions are likely in 2023** — equity valuations are cheap, however, the challenges remain formidable with the potential for negative surprises. It is too early to emphasise European assets.
- **Multi-asset portfolios need to remain flexible, diversified and robust** — we have added to conventional bonds at higher yields, emphasise earnings resilience and value in equity portfolios, and consider physical gold to offer key diversifying properties for 2023.
- **We are more optimistic than most, particularly for the US, where the majority of equity capital is deployed.** Across the portfolio we aim to be different from the broad market index, emphasising specific areas of strength and opportunity.

INTRODUCTION

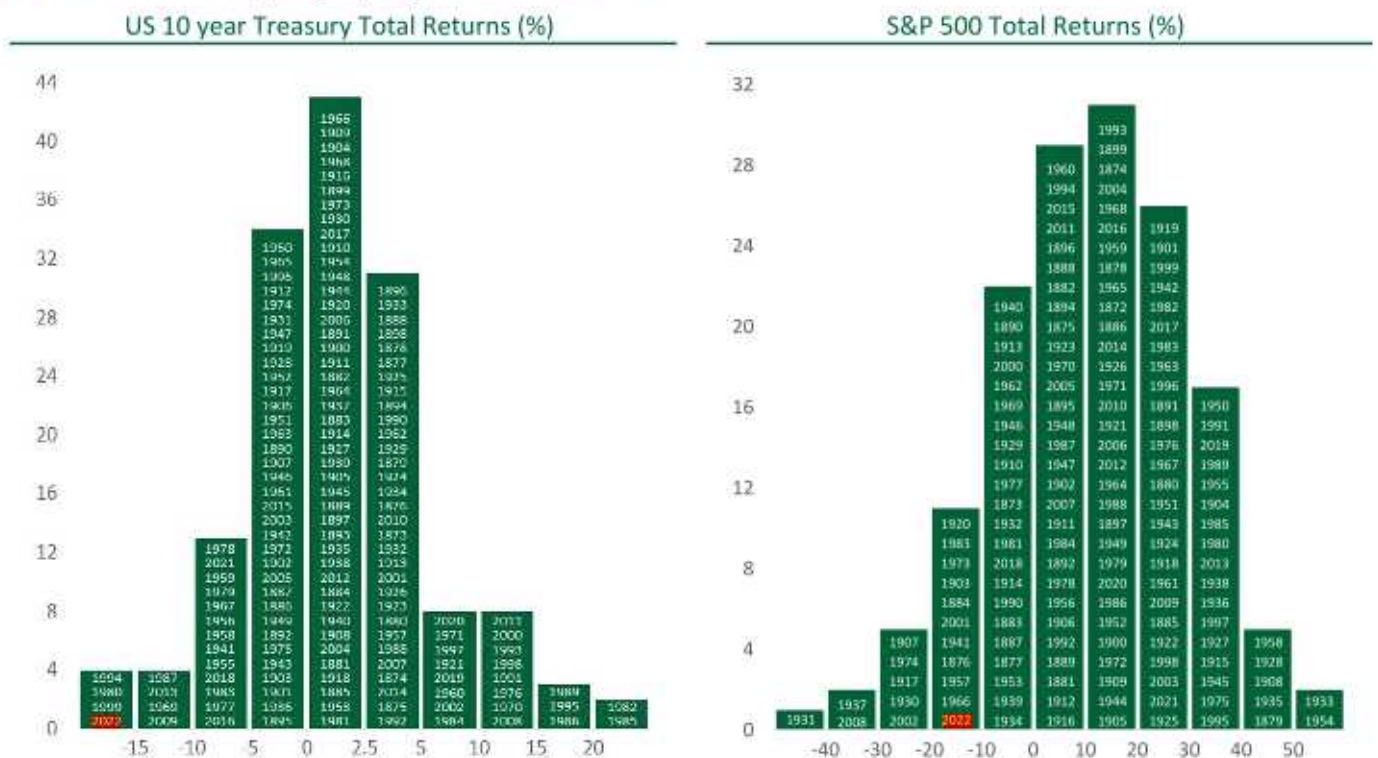
There is no doubt that 2022 will be remembered for all the wrong reasons. An unjustifiable war in Europe has caused tragic loss of human life, whilst acting as the catalyst for fierce economic headwinds around the world. As commodity prices have soared, real incomes have been hit hard by rampant inflation. Meanwhile, the pandemic that began almost three years ago remains undefeated, particularly in China, where haphazard lockdown policies have constrained growth, both domestically and globally. In contrast to the market dynamic of recent years, central banks have added to economic woes by tightening financial conditions fearing a period of runaway inflation.

For financial markets, this has been a perfect storm. Higher interest rates have led to a meaningful valuation reset, particularly for disruptive technology stocks that were previously trading at premium multiples. As inflation has risen and growth expectations have been revised down, so too have earnings estimates for 2023. European assets have suffered a sharp deterioration in sentiment, as the Russian invasion of Ukraine continues to depress economic activity. The same is true for Emerging Markets, as US Dollar strength and a slump in Chinese demand have led to underperformance. The MSCI AC World global equity index finished the year at -18.0% while the MSCI Emerging Markets index posted -20.0%¹.

Usually we are reminded of the benefits that diversifying into bonds offers to a portfolio dominated by equities. But with interest rates rising sharply, bonds suffered a similar fate to equities last year.

In the past year the yield on a 10 year US Treasury bond has risen from c. 1.5% to c. 3.9% today, and as a result the global bond market returned -11.2% in 2022. As Chart 1² shows, steep declines in both of the major asset classes in the same year is rare, creating one of the worst years for conventional multi-asset portfolios on record.

Chart 1: A historically painful year for stocks and bonds



¹ Source: Bloomberg, USD, December 2022.

² Source: Bloomberg, Alpine Macro, USD, December 2022.



INVESTMENT STRATEGY FOR 2023

Whilst it can always be said that the outlook for economic and geo-political conditions is uncertain, and at risk of unforeseeable events, this is particularly true today. The economic cycle has been highly disrupted by pandemic, war and profound shifts in monetary policy over the past three years. As a result, several different investing environments have varying likelihoods of playing out over the next 12–24 months.

Our investment philosophy emphasises balance and diversification and these principles are held with the highest conviction at the current time. An investment strategy which positions for one outcome may prosper over a short period of time, but our experience tells us that a more robust approach is to cater for several.

As truly long-term investors, our multi-asset portfolios lean into assets with strong growth, quality and/or value characteristics, which we expect to deliver over the course of a full market cycle. Despite uncertainty, these principles remain steadfast. We elaborate on some core ideas that are reflected in portfolios in [Section 2](#). In [Section 1](#), we outline some of the biggest macro issues for this year and our assessment of each.

Section 1. Key macro issues for 2023

1.1 US Recession

Given the avalanche of negative economic data points in recent months, a chorus of US recession forecasts have followed. In fact, despite the above context on macro uncertainty, economists have never been so united in their dismal expectations (see [Chart 2](#)³). Based on the early 1980's analogue, when Fed Chair Paul Volcker engineered a deep recession to control inflation, it is assumed 'demand destruction' will again be required in 2023 to address price pressures.

Chart 2: The most anticipated US recession in history



There is no doubt that the risk of US recession in the coming 12–24 months is higher than normal, with several economic warning lights flashing red. However, with such a disrupted cycle in mind, the economy could continue to follow an unconventional path. History can repeat itself, but we have few examples of a global pandemic and European war to offer precedent for the most likely future economic path. Confounding economists, inflation could fall further and faster than expected, and without the requisite recession.

³ Source: BCA Global Research, Federal Reserve Bank of Philadelphia, December 2022. Shaded areas denote US recession.

1.1.1 Is a 'soft landing' possible?

We have been anticipating declining inflation since the summer, outlining the supportive combination of normalising goods demand, supply chain improvements, lower gasoline prices and declining wholesale margins in recent quarterly letters. This is now more evident, with recent inflation readings undershooting expectations.

The important question is, how can inflation fall rapidly from here and recession be avoided? The answer lies in the labour market.

With such an excess of job openings over available workers, wage growth surged in 2021. This is very unusual, and was not a feature of the US economy in the early 1980's. Back then, sky high inflation expectations required a recession in order to restore price stability. Now, however, wage growth can moderate as a consequence of fewer job vacancies rather than widespread layoffs. We are already seeing this play out. In turn, service sector inflation should ease, which combines with the already evident goods and energy dis-inflation. Importantly, inflation expectations remain well anchored and are not calling for painful economic treatment.

1.1.2 Structural drivers of US leadership

An important theme of the past couple of years has been 'regime change' — economically, financially and geo-politically. In particular, the Russian invasion of Ukraine and associated energy supply shock has arrested the gradual slowdown of globalisation. Indeed, terms such as de-globalisation, localisation and friend-shoring, are now commonplace in the investing vernacular.

Put simply, global supply chains are changing, with the location of producers no longer a function of cost alone. Government and corporates need to adapt to an environment which prioritises supply chain security, resilience and diversity.

We consider the US to be a key beneficiary of the 'de-globalisation theme'. Trade is not a significant growth driver, at c. 10% of GDP, despite being a net exporter of both energy and agricultural products. This offers an economic agility that is hard to find, particularly when combined with a diverse and well educated workforce, deep capital markets and common language. Furthermore, recent government legislation demonstrates a rare bipartisan commitment to adapt. One should not confuse headline grabbing turmoil on Capitol Hill with a broader focus on getting things done.

\$2 trillion of new federal spending has been signed into law since late 2021, aiming to improve US competitiveness, innovation and industrial productivity over the coming decade.

The CHIPS Act of August 2022, which aims to catalyse investments in domestic semiconductor manufacturing and R&D, directs c. \$280 billion into the economy. The speed at which this bill has been passed, along with the Bipartisan Infrastructure Law and Inflation Reduction Act, is refreshingly impressive.

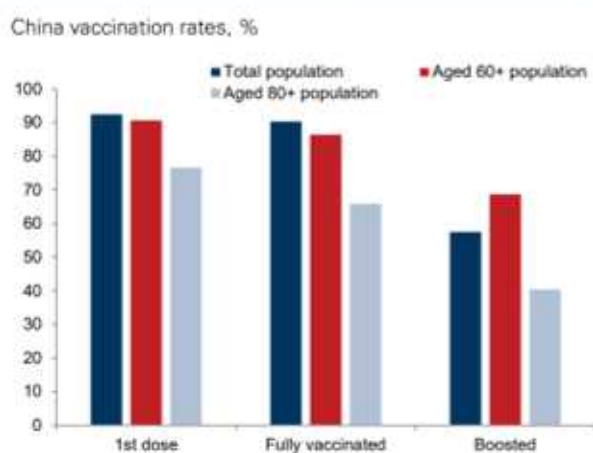
Our assessment: We believe a soft landing, characterised by growth slowing but avoiding a 'broad-based weakening', is fairly likely, yet under-appreciated. In addition, the longer term US growth picture is increasingly supported by new structural drivers.

1.2 China post zero-covid reopening

The pandemic management approach adopted by the Chinese authorities, seemingly so successful in 2020, ultimately proved to be calamitous in 2022. Rolling lockdowns, subjecting millions to house arrest and quarantine, eventually triggered a rare outbreak of public defiance late last year, panicking the government into a hasty policy-pivot. The prospect of ‘zero covid policy’ making way for a gradual economic reopening this year supported by increased vaccination, now appears likely.

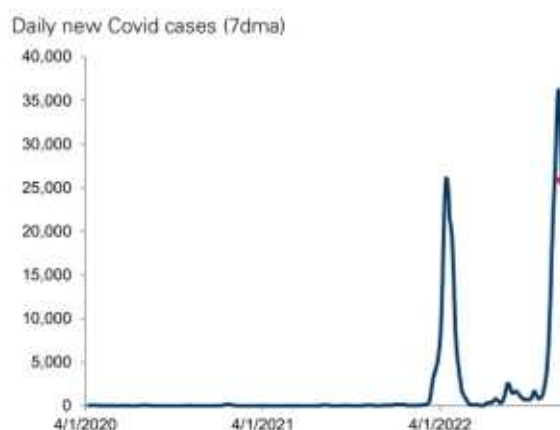
This development poses a number of uncertainties for global investors. Importantly, we are yet to understand how the transition away from pandemic restrictions will be managed, and whether it will be successful. Most expectations are for some restrictions to remain until the spring at the earliest, noting a relatively low level of vaccination coverage amongst the elderly and a lack of medical readiness (Chart 3⁴).

Chart 3: Chinese vaccine coverage remains relatively low



There is little doubt that infections will surge as the virus spreads through a previously under-exposed population of approximately 1.4 billion people. As Chart 4⁵ shows, this is already playing out, with a reported 248 million people contracting the virus in the first 20 days of December⁶. To what extent will this be tolerated by the authorities and the public? Could rolling lockdowns return? Could China experience cases and serious illnesses at lower than expected levels? The answers to these questions are clearly unknowable at the current time, but we are likely to find out before long.

Chart 4: A Covid surge in China is already underway



President Xi Jinping has consolidated political power in recent months, removing institutional checks and balances, which in turn raises governance risks. In addition to getting the post-pandemic reopening right, the authorities need to manage a real estate downturn, ensuring it is sufficiently supported by monetary and fiscal policy, and contend with continued sluggish demand from abroad. In contrast to the Global Financial Crisis of 2007/08, the authorities do not have the option of stimulating the domestic and global economy through large scale credit expansion. What is knowable, is that China needs a lot of good luck this year.

Our assessment: Whilst the intention to end zero-covid policy is a positive development, it is likely to be a bumpy ride. This uncertainty justifies a meaningful valuation discount for Chinese markets, which we will be surprised to see dissipate in the short term. Despite the recent ‘China reopening’ market rally, we approach investment in the region with a suitable level of caution.

⁴ Source: Goldman Sachs Global Research, December 2022.

⁵ Source: Goldman Sachs Global Research, December 2022.

⁶ Source: Bloomberg, 23 December 2022.



1.3 A European recovery?

The economic challenges facing Europe are quite different to those in the US. Inflation has been mostly driven by energy supply disruption, with wage growth and durable goods spending at modest levels. Thanks primarily to fiscal support, the Eurozone economy held up remarkably well in 2022, although most signs point to a recession already in motion as 2023 gets under way.

The UK faces similar challenges, with real disposable incomes being hit hard by climbing energy, food and mortgage costs. In addition, political 'own goals' last year have motivated a more austere fiscal stance, leaving consumers facing continued reducing government support and higher taxes.

Sentiment towards European assets has rarely been so negative, and this in itself could spur an unexpected recovery. After such a relentless flow of bad news for the region, a modest change of fortunes may be all that is required.

One thing that has surprised positively in the past year is the progress made to displace Russian gas. Germany recently completed the construction of its first floating LNG terminal in an unprecedented 194 days and plans are in place for several more this year⁷. Evidence of energy stability, combined with economic improvement driven by a gradual reopening of China, for example, could boost sentiment and support the equity market.

Of course, the primary threat to European stability this year is the next phase of the Russia-Ukraine war. President Putin's strategy of military aggression has backfired across the board, from Ukraine's heroic resistance, to NATO solidarity and the European energy transition. The risk is that Russia engages in a strategy of escalation, rather than cessation, delivering negative surprises to European investors. Most geopolitical analysts consider this as an improbable scenario, with a pivot to halt the Ukrainian offensive more likely, offering Putin the opportunity to claim a dubious victory.

Our assessment: Economies in the Eurozone and the UK are unlikely to avoid recession in the first half of this year. Sentiment is very depressed and equity valuations are cheap, however, the challenges remain formidable. Periods of relative strength are likely to be short-lived. We continue to believe it is too early to emphasise European assets, and are mindful of the potential for negative surprises.

Section 2. Portfolio allocation

2.1 Striking the balance

Is there a good chance that these themes play out in ways we do not expect? Absolutely — there is no historical playbook upon which we can rely. A policy mistake by the Federal Reserve, tightening financial conditions too much and engineering an unnecessary recession, is the most obvious risk for the US economy. Developments in Asia and Europe could surprise us positively, with a more convincing economic recovery and cooling of geo-political issues. In the same way, an unforeseen negative shock could create a new set of challenges that become the primary source of market volatility this year.

This means multi-asset portfolios need to remain flexible, diversified and robust. Portfolio adjustments in 2022 focused on tilting away from assets considered to be vulnerable to the economic fragility, whilst emphasising resilience and quality.

Emerging market local currency debt and Chinese sovereign debt were sold early in the year, and European equities were reduced in favour of the US. We increased allocations to large cap UK equities, motivated by a higher weighting to energy, industrials and commodity-sensitive sectors in the FTSE 100 index, and reduced exposure to low-profitability businesses. Several of our favoured managers also adapted to this regime.

⁷ Source: Euractiv, November 2022.

For 2023, we emphasise three portfolio themes, and how they cater for the uncertain macro backdrop that we describe:

2.1.1 Bonds reclaim their diversification and total return merits

Having avoided traditional government bonds for several years, we incrementally added Treasuries and Gilts to relevant portfolios last year. With medium-term issues now yielding 3.5% to 4.0%⁸, high quality bonds are offering holders to maturity both income generation and capital growth in the coming years. In this uncertain environment such characteristics offer merit.

In addition, bonds offer diversifying qualities that have been absent in the past year. Should a deep US recession become evident, the Federal Reserve are likely to adapt their thinking on monetary tightening, and bond yields should shift lower.

We are watching developments in the fixed income market closely for opportunities to build these positions further, as well as in selective credit

2.1.2 Prioritise earnings resilience and valuation discipline in equities

The equity market has been trending down for the past year, discounting lower valuations and profit downgrades. With the consensus calling for US recession in the coming months, further market weakness is also commonly cited as an inevitability. We would not rule this out, particularly in the short term, as volatile periods often take time to evolve into phases of durable strength.

Attempting to ‘time’ such a short-term period of volatility through aggressive asset allocation adjustments remains absent from our investment approach. Just as the US economy may prove more resilient than expected, earnings expectations and market valuations may also hold up. As Charts 5⁹, 6¹⁰ and 7¹¹ show, global valuations compare favourably to long-term averages, earnings estimates have been revised down, and the market decline already reflects a period of recession. As American economist Paul Samuelson once quipped, stock markets have predicted nine of the past five recessions.

Chart 5: Global valuations look attractive following reset

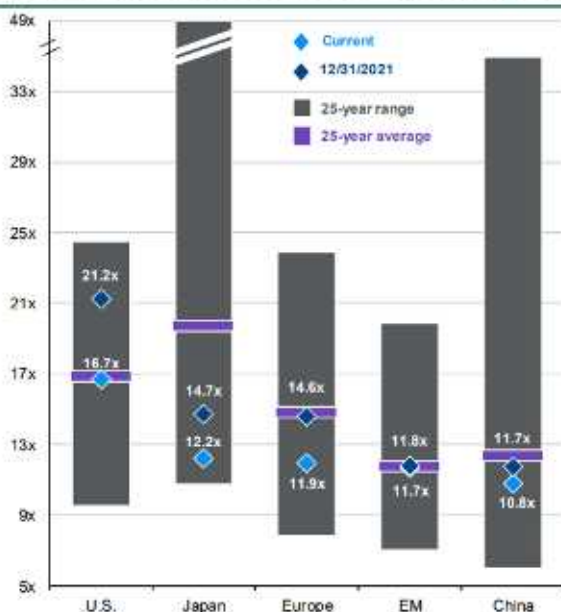
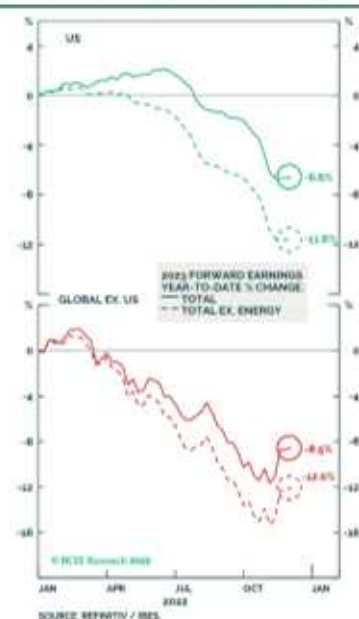


Chart 6: EPS downgrades reflect pessimism



⁸ Source: Bloomberg, December 2022.

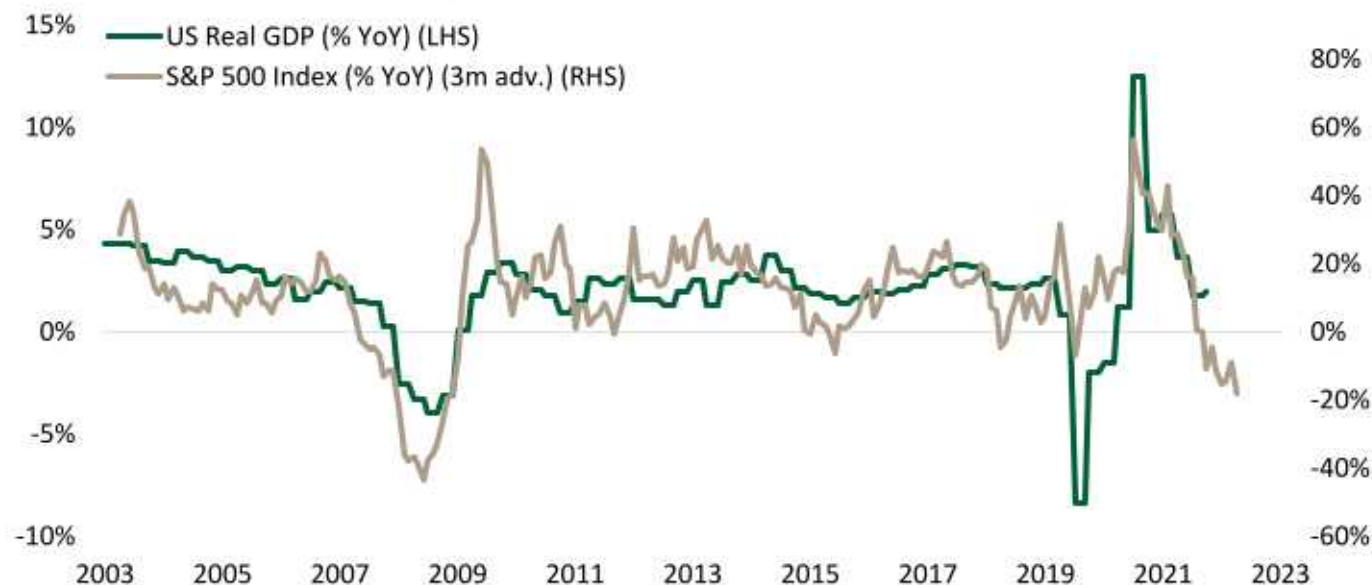
⁹ Source: JP Morgan Guide to the Markets, Q4 2022. Current and 25 year price to forward earnings ratio.

¹⁰ Source: BCA Global Research, December 2022.

¹¹ Source: Oxford Economics, December 2022.



Chart 7: US market declines already reflect recession



Our strategy in equity portfolios is to remain selectively engaged with a defensive bias. Whilst investment ‘defensiveness’ could be defined in several ways, our approach is to tilt portfolios to sectors and strategies considered least vulnerable to current market risks.

Through selected managers and strategies, we aim to own a blend of underlying companies which together are likely to deliver solid earnings growth at appropriate valuation multiples. Regionally, we favour the US, and see increasing opportunities in Healthcare, Insurance and smaller companies.

Finding corners of the market which exhibit less earnings risk, and are valued attractively, is the ultimate goal in this environment. The Healthcare sector is a good example, which represents a significant active allocation for many of our equity portfolios. As one of our US active managers noted in a recent commentary, “National health care expenditures represent about 20% of domestic GDP at \$4.1 trillion. This number is expected to grow at an annual rate of 5.4% — more than one percentage points higher than projected GDP growth¹²”. Healthcare insurers that combine scale and differentiated business models, taking advantage of new technologies to engage with patients and lower overall costs, as well as demographic tailwinds, are in a strong position. Market leaders are expected to retain attractive margins and deliver stable earnings growth, against a backdrop of elevated economic uncertainty.

2.1.3 Physical gold offers portfolio insurance in multiple scenarios

Gold is held in our multi-asset strategies as a source of uncorrelated return and portfolio insurance. With no earnings or income stream it is an asset that behaves very differently to the core of the portfolio, dominated by equities and bonds.

In 2022, physical gold failed to live up to its status as safe haven and inflation hedge, delivering roughly flat returns in US Dollars. Looking forward, we see a myriad of possible environments which could be supportive for the precious metal. In particular, US Dollar strength has ebbed in recent months, as the Federal Reserve have signalled they are preparing to slow the pace of monetary tightening. Having focused on the inflation fight last year, they are now more mindful of the growth consequences of higher interest rates.

A more balanced approach from the Federal Reserve, and certainly one that pivots to rate cuts in the face of recession, could lead to continued weakness in the US Dollar. This is likely to be favourable for physical gold.

¹² Source: Artisan Partners, September 2022.



The geo-political landscape is also likely to generate demand for physical gold. With Russia's foreign exchange reserves frozen, other sizeable governments, such as China, are increasingly diversifying away from US Dollar assets. As the Financial Times reports, "*data compiled by the World Gold Council, an industry-funded group, has shown demand for the precious metal has outstripped any annual amount in the past 55 years*¹³."

Central banks and governments are facing a new set of economic challenges, and the diversifying properties of precious metals could be very valuable in a portfolio of financial assets. We remain confident of the merits of retaining gold as a key component of our strategy.

Concluding remarks

In a year characterised by profound economic, geo-political and financial change, our strategy continues to concentrate on areas of strongest conviction. This will remain a key theme in 2023, retaining appropriate balance to reflect a multitude of macro possibilities. We are more optimistic than most, identifying evidence for economic resilience particularly in the US, where the majority of our equity capital is deployed. Across the portfolio we aim to be different from the broad market index, emphasising specific areas of strength and opportunity. There is little doubt that volatile conditions will not disappear, and patience is required, but our long-term discipline ensures we retain focus and pursue stronger results over time.

We wish you all a Happy New Year and a prosperous 2023.

SFIM Investment Committee
January 2023

¹³ Source: Financial Times, "Gold buyers binge on biggest volumes for 55 years", 29 December 2022.

RISK DISCLOSURE

This document has been prepared for information only and is not intended for onward distribution. It is neither an offer to sell, nor a solicitation to buy, any investments or services. The information on this document does not constitute legal, tax, or investment advice. It does not constitute a personal recommendation and does not take into account the individual financial circumstances needs or objectives of the recipients. You must not, therefore, rely on the content of this document when making any investment decisions.

Any information which could be construed as investment research has not been prepared in accordance with legal requirements designed to promote the independence of investment research. Further it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Past performance is not a guide to future returns. If the information is not displayed in your base currency, then the return may increase or decrease due to currency fluctuations.

All investments risk the loss of capital.

The value of investments may go down as well as up, and for products designed to return income, the distributions can also go down or up and you may not receive back the full value of your initial investment.

Changes in the rates of exchange between currencies may cause the value of investments to go up or down in the reporting currency.

Persons in possession of this document should observe any applicable legal requirement in relation to the possession of this Information in that jurisdiction. Any overseas recipient should consult its professional advisers as to whether it requires any governmental or other consents, or if it needs to observe any formalities to enable it to receive or respond to this communication.

Whilst every effort is made to ensure that the information provided to clients is accurate and up to date, some of the information may be rendered inaccurate by changes in applicable laws and regulations.

Issued by Stonehage Fleming Investment Management Limited (SFIM). Authorised and regulated by the Financial Conduct Authority (194382) and registered with the Financial Sector Conduct Authority (South Africa) as a Financial Services Provider (FSP No. 46194).

In addition to the information provided by SFIM, you may wish to consult an independent professional.

R&C: 2022_2023_004

