2023 Investment Outlook

SEASPRAY PRIVATE
Creating Investment Solutions

Executive Summary

2022 – A year many will want to forget – but will stay long in the memory!

2022 will rank as one of the most turbulent years for markets since the Global Financial Crisis of 2008 with the main drivers – February 24th and Putin's invasion of Ukraine coming at a time when the world was seeking to emerge from the global pandemic, bringing significant human, economic and financial dislocation across the globe. We saw soaring energy and food prices, record-breaking inflation not seen since the 80's, multiple stock sell-offs, with the technology sector leading declines, significant and aggressive rate tightening from central banks, a bear market and, in the UK, the most extraordinary events following the Truss/Kwarteng mini-budget and the implosion of UK financial markets and forced intervention of the Bank of England.

Without question, inflation dominated the economic landscape in 2022, with both the ECB and the Fed at their December meetings reinforcing price stability and a continued hawkish stance, raising interest rates by another 50bp to further combat inflation. These increases were smaller than the earlier hikes of 2022, which could be a sign that inflation is cooling down and indeed has peaked. For now, inflation is still stubbornly high, and it could be some time before it normalises. However, most metrics are pointing to a sharp fall in inflationary pressures over the coming months not just in the US but around the world, which should help support asset prices.

Clearly, markets are never easy to predict, hardly ever straight-forward, and are driven by a number of complex factors. However, as we move through Q1 and Q2 we see it as increasingly likely that government and corporate bonds will outperform equity markets. As we have alluded to in previous investment updates over the past few months, we believe an opportunity to go overweight equity markets will indeed present itself, as we see central banks making a dovish shift at some stage during the middle period of this year. What would confirm this further would be if we begin to see earnings bottom out or even turn back upwards after what is expected to be a weaker Q4 and likely Q1 performance.

60/40 portfolios had one of their most volatile periods on record over the past 12 months. During times like these, it can be hard to look beyond the present and plan for the future. But it is precisely at these moments that financial planning is more important than ever. In our 2023 Outlook, we will discuss our views on what 2023 might look like for the economy, our clients' financial lives, and the long-term opportunities that periods of volatility in markets present.

For 2023, we believe peak inflation and peak policy will provide us with an investment backdrop ripe with opportunity, and we feel that asset prices will fare better over the course of the year as markets have already priced in the lagging impact of rate rises.

Our key macroeconomic and market-related calls for 2023

1. Equities turn 'risk-on' in mid-2023

With global inflation, the US dollar and central bank hawkishness peaking in the first half of 2023, we expect stock markets to tolerate more risk later in the year. Equities will typically reach their bottom six months ahead of the end of a recession, and as a result bonds appear more attractive in the first half of 2023, while the backdrop for stocks should be better in the latter half.

2. Rates

Global yields will likely lead central bank policy paths, with potential differentiation due to regional energy exposure. We expect rates to top out in early-2023, though acknowledge the risk to the upside in the short-term given policymakers' aggressiveness and determination to tame inflation. Globally, we believe the deepest of curve inversion is now behind us. Both 2-year and 10-year US Treasuries should end 2023 around 3.25%. Sectors hurt by rising rates in 2022 may benefit in 2023.

3. Monetary policy

Sticky inflation likely remains the dominant global concern during the first quarter at least, locking central banks into a pause-over-pivot bias. Consequently, policymakers are eager to nudge growth below potential. In the US, we expect a terminal rate of 5 – 5.25%, with the possibility of a cut towards the end of the year. In the Eurozone and UK, terminal rates may reach 3.25% and 4.50%, respectively.

4. A recession is all but inevitable in the US, Eurozone, and the UK

It has become increasingly more likely that the US will experience a mild recession in the first half of the year with a risk that it starts slightly later than expected. Europe likely sees recession at the beginning of the year with a shallow recovery then as the ECB and BOE are forced to pause rate hikes. The United Kingdom may take longer to emerge from this recession.

5. Disinflation

Prices should slowly cool, with notable improvement in the policy-critical areas of shelter and wages. Supply chains have functioned better as of late, with further improvements likely if China is able to fully emerge from its Covid restrictions. Still, wage growth and long-term inflation expectations will be key factors in forward monetary policy.

6. Geopolitics

Acute geopolitical dynamics will remain present as ever, hallmarked by ongoing conflicts in Ukraine, territorial flexing by China, and entrenched societal polarization. On the latter, we expect increasing uncertainty in government composition and policy.

Our key macroeconomic and market-related calls for 2023, contd.....

7. Currency

Some short-term US dollar strength may persist as global growth is to the downside. Over the medium and longer term, the dollar looks vulnerable to high valuation and global recovery. Should the global growth-inflation mix improve, the USD is likely to undo much of last year's gains.

8. Emerging markets (EM)

After a volatile 2022, EM should produce strong returns. Once inflation and rates peak in the US and China reopens, the outlook for EM should turn more favourable. Chinese equities especially will likely strengthen due to a reversal in both zero-Covid and property tightening.

9. Energy

Russian sanctions, low oil inventories, China's reopening, and an OPEC that is willing to cut production in case demand weakens should keep energy prices higher for longer.

10. Unemployment & the consumer

Consumers should get some relief on prices, but may also become less willing to spend given the wealth effect and as labour markets worsen. Labour markets should finally ease in 2023 - the US unemployment rate should peak at circa 5.5% in early 2024 and Eurozone at 7.5%, hindering consumer spending somewhat.

"For 2023, we believe peak inflation and peak policy will provide us with an investment backdrop ripe with opportunity, and we feel that asset prices will fare better over the course of the year as markets have already priced in the lagging impact of rate rises....."

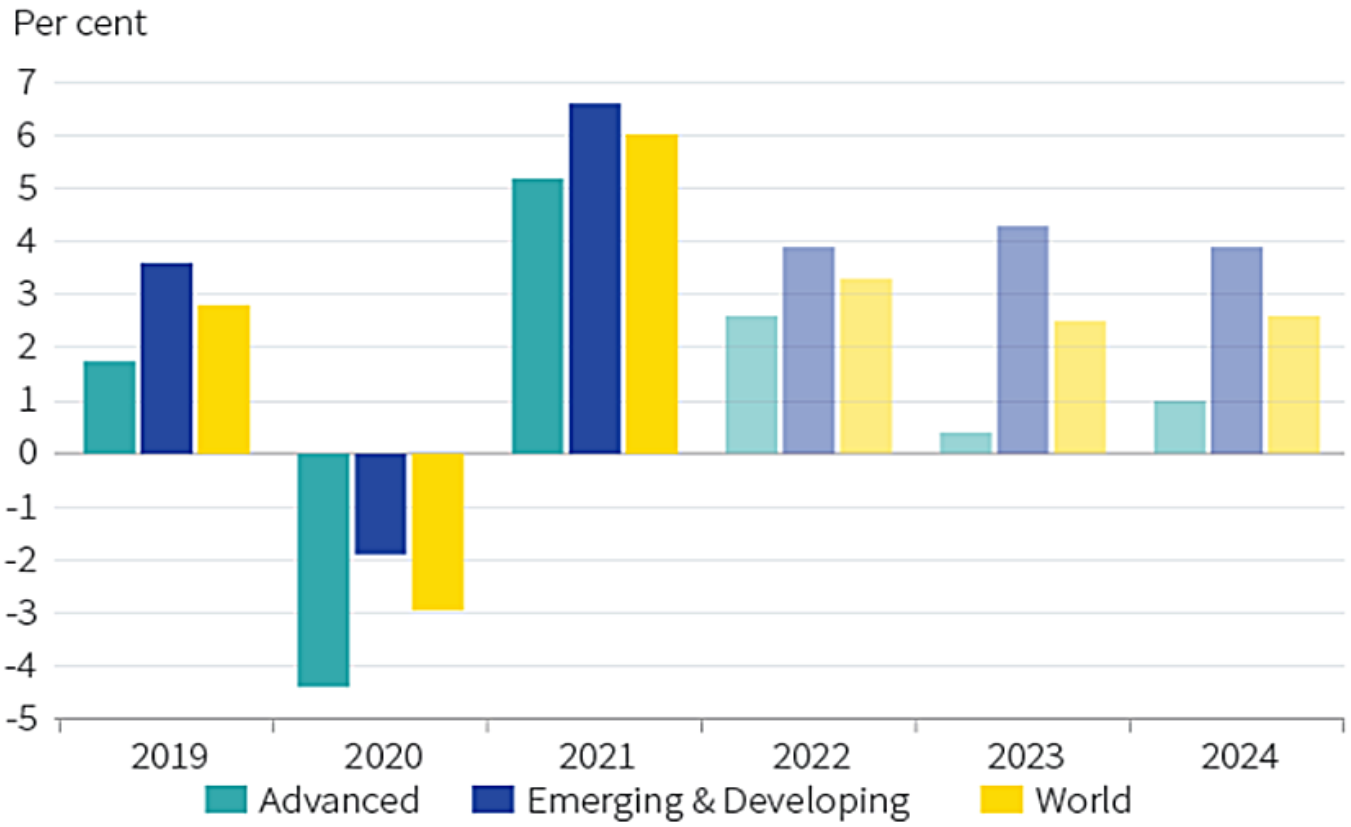
	2022	2023 YTD
Equity Indices		
S&P 500	-19.4%	3.1%
Nasdaq	-33.1%	3.9%
DAX	-12.4%	7.9%
EuroStoxx 50	-11.7%	8.6%
ISEQ	-15.8%	8.9%
FTSE	0.9%	4.4%
Multi-Asset Funds		
Aviva Multi-Asset ESG 3	-11.0%	1.6%
Irish Life MAPS 3	-8.8%	1.3%
New Ireland iFunds 3	-6.1%	0.8%
New Ireland PRIME 3	-7.7%	0.9%
Zurich Prisma 3	-8.1%	0.8%
Aviva Multi-Asset ESG 4	-11.2%	2.0%
Irish Life MAPS 4	-9.2%	1.5%
New Ireland iFunds 4	-7.1%	1.0%
New Ireland PRIME 4	-10.0%	1.4%
Zurich Prisma 4	-12.7%	1.4%
Aviva Multi-Asset ESG 5	-11.0%	2.3%
Irish Life MAPS 5	-11.8%	2.2%
New Ireland iFunds 5	-7.6%	1.6%
New Ireland PRIME 5	-10.5%	1.9%
Zurich Prisma 5	-16.2%	1.8%
Currencies		
EUR/USD	-5.9%	0.6%
EUR/GBP	5.3%	0.5%
GBP/USD	-10.6%	0.2%
USD/JPY	13.9%	-0.6%
Fixed Income		
US 10yr	2.37	-0.33
German 10yr	2.68	-0.43
Irish 10yr	2.88	-0.57
UK 10yr	2.70	-0.29
Commodities		
Gold	-0.2%	3.2%
Brent Crude Oil	10.5%	-2.6%

Source: Seaspray, January 2023

Risks & Global Economy

The main issue for 2023 is whether inflation pressures ease by enough to allow central banks to step away from rate hikes and pause or potentially even begin easing. We expect inflation to be on a downward trend as global demand slows over the coming months – early signs are already pointing to significantly lower inflation this year. In our view, this will allow central banks to eventually change direction and set the scene for the next economic upswing in late 2023 and early 2024. In the United States, we believe a recession has now become the most likely outcome this year, given the extent of monetary tightening. However, with household and corporate balance sheets in good shape and no significant obvious economic imbalances, aside from still-elevated inflation, we expect the downturn to be mild compared to previous recessions. In the eurozone, the outlook has improved marginally, as it now appears energy rationing will not be required and forced shutdowns of energy-intensive industries are unlikely. That said, we must reiterate that a recession still appears unavoidable because of the impact of the Ukraine war, weak external demand, high energy and food prices, ongoing supply bottlenecks, and tighter monetary policy.

As can be seen on the graph below in yellow, global growth is expected by many analysts to slow to about 2.5% in 2023 and 2024, down from 3.25% last year. Taking a closer look, developed market economies are expected to account for all of this slowdown, with growth of just 0.5% expected this year and 1% next, down from 2.5% in 2022. That largely reflects the impact of both the energy shock Europe, dragging down real disposable income and spending, alongside the restrictive stance of monetary policy in developed regions weighing on their respective households and businesses.



Source: Aviva Investors, Macrobond

In emerging markets, growth is expected to be a little stronger in 2023, rising by over 4%, driven in part by an improvement in China as it exits its harsh restrictions of 2022. Clearly, downgrades for emerging and developing economies have been lower than for the major developed nations. One explanation is that many such countries hiked rates sooner and more aggressively, meaning the policy-induced element of downturn may be more pronounced. Outside of Europe, emerging markets are also not being as badly impacted by the energy shock.

But even with these regional differences, the global outlook overall is deteriorating. World GDP growth may struggle to reach 2.5% in 2023 should we see further adverse developments with regard to geopolitics, inflation, or other significant issues. Historically, outright declines in world GDP are very rare, as certain better-performing areas usually make up, at least in part, for others. Many regions and countries will experience recession over the coming year and even if some manage to avoid it, we think the threat will remain throughout H1 and quite possibly beyond. There are two significant risks for investors associated with a looming recession: 1) Will earnings nose-dive as the consumer is forced to rein in spending? 2) Will central banks continue to fight last year's war (inflation) despite recessionary conditions, or might they reverse direction? Both factors have the potential to be a source of volatility in early 2023. We would also like to state that the world economy does not have anything like the scale of vulnerability from over-leveraged private balance sheets and under-capitalised banks which have characterised previous recessions (such as the financial crisis in 2008) and this means that any downswing can indeed be relatively shallow and short-lived.

The war in Ukraine was a significant driving factor for markets during most of 2022. Sadly, we do not see a de-escalation of conflicts occurring any time soon. In fact, most strategists believe that conditions for a lasting ceasefire, let alone a formal peace settlement, are unlikely to be met this year. Freezing present positions would satisfy neither side as it stands. Vladimir Putin would not have broken Ukraine's independence, or even fully control the four regions it annexed in September. President Volodymyr Zelenskyy cannot accept a ceasefire leaving Ukraine without the territory lost since Russia's invasion in February, on top of occupied Donbas and Crimea, seized in 2014. Russia has pulled back out of certain regions and is seemingly trying to regroup and prepare its people for a long war. A continued, grinding conflict is most likely in our view.

United States

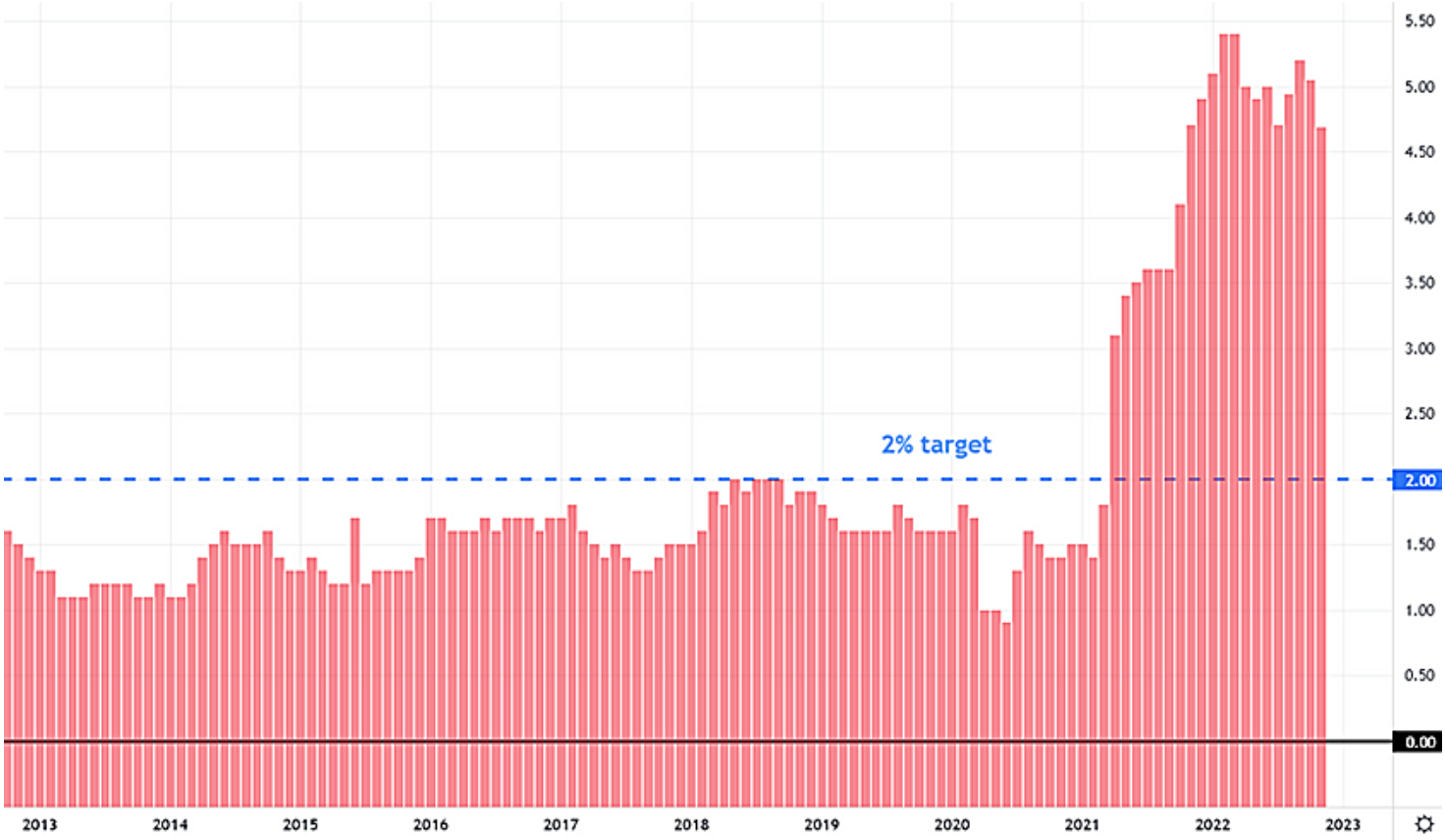
At present, inflation clearly remains the dominant issue for the United States and its financial markets. It has pressured the Federal Reserve into prioritising price stability over economic expansion which, in turn, has cast a cloud over the outlook for corporate profits and asset prices. The duration and magnitude of the inflation overshoot has already pushed monetary policy close to or into restrictive territory. We now believe the most likely scenario is for a mild US recession at some stage this year. We believe private sector balance sheets remain healthy in the States, inflation expectations are definitely more settled than they were in the 1970s, and healing global supply chains should allow volatile inflation drivers (such as durable goods inflation) to flip back toward secular deflation. These factors argue against the minority expectation for a severe economic contraction.

The labour market is still overheated in America and correcting that imbalance will likely require some pain, such as higher unemployment as the economy cools this year. It is still somewhat unclear to what extent markets have priced in this risk. The equity market outlook is mixed for the United States with a struggle of sorts between negative cyclical dynamics and oversold sentiment (chart below shows strong positive S&P 500 returns in the 12 months following each trough in sentiment). US Treasuries are now offering investors with positive real yields and are looking like an attractive investment in the context of a widespread global slowdown and potential further short-term volatility in the stock market.

Source: FactSet, Standard & Poor's, University of Michigan, JP Morgan Asset Management.

2022 was without a doubt an historic year for American investment markets. Looking back over the last 150 years of US equity and bond performance, last year is currently the only year where stocks and long-term bonds were both down over 10%. Several factors occurred in order to create such an unusual outcome. To start, valuations for both stocks and bonds were expensive – growth was weak in China but surprisingly resilient in developed markets such as the US. That resilient growth ended up helping to drive the highest rates of inflation in four decades. And that high inflation in turn invited a strong response from the Federal Reserve, who increased their target rate at the fastest pace over a 12-month period since the early 1980s. Looking ahead, the next 12 months look very different in our opinion, across all of those factors. First, starting valuations look different – US BB rated high-yield corporate bonds began 2022 yielding just 3.4%, they currently yield 6.5%. The S&P 500 stock index began the year at 22x forward earnings. That has now fallen to circa 16.6x.

Since the release of our Interim Investment Update at the beginning of December there has not been a huge amount of fresh economic data from the States. We have however seen both consumer prices and producer prices continue to decline over this period, albeit with the PPI result slightly ahead of analysts' expectations at 7.4% y/y. The Fed's preferred inflation gauge — the core personal consumption expenditures (Core PCE) price index came in at 4.7% towards the end of last month. This was in line with forecasts and is down from the previous 5.0%, as can be seen below.



Source: Seaspray, January 2023

Weaker developed market growth this year should lead to weaker developed market inflation across the board. After hitting 40-year highs in 2022, our forecasts show US headline inflation falling sharply next year, with US CPI heading back towards 2% throughout the year. Weaker demand, high inventories, lower commodity prices, healing supply chains, a cooler housing market, and easier y/y comparisons are all part of our lower inflation forecast. As growth slows and inflation moderates, central banks will likely gain more confidence that they have taken rates high enough.

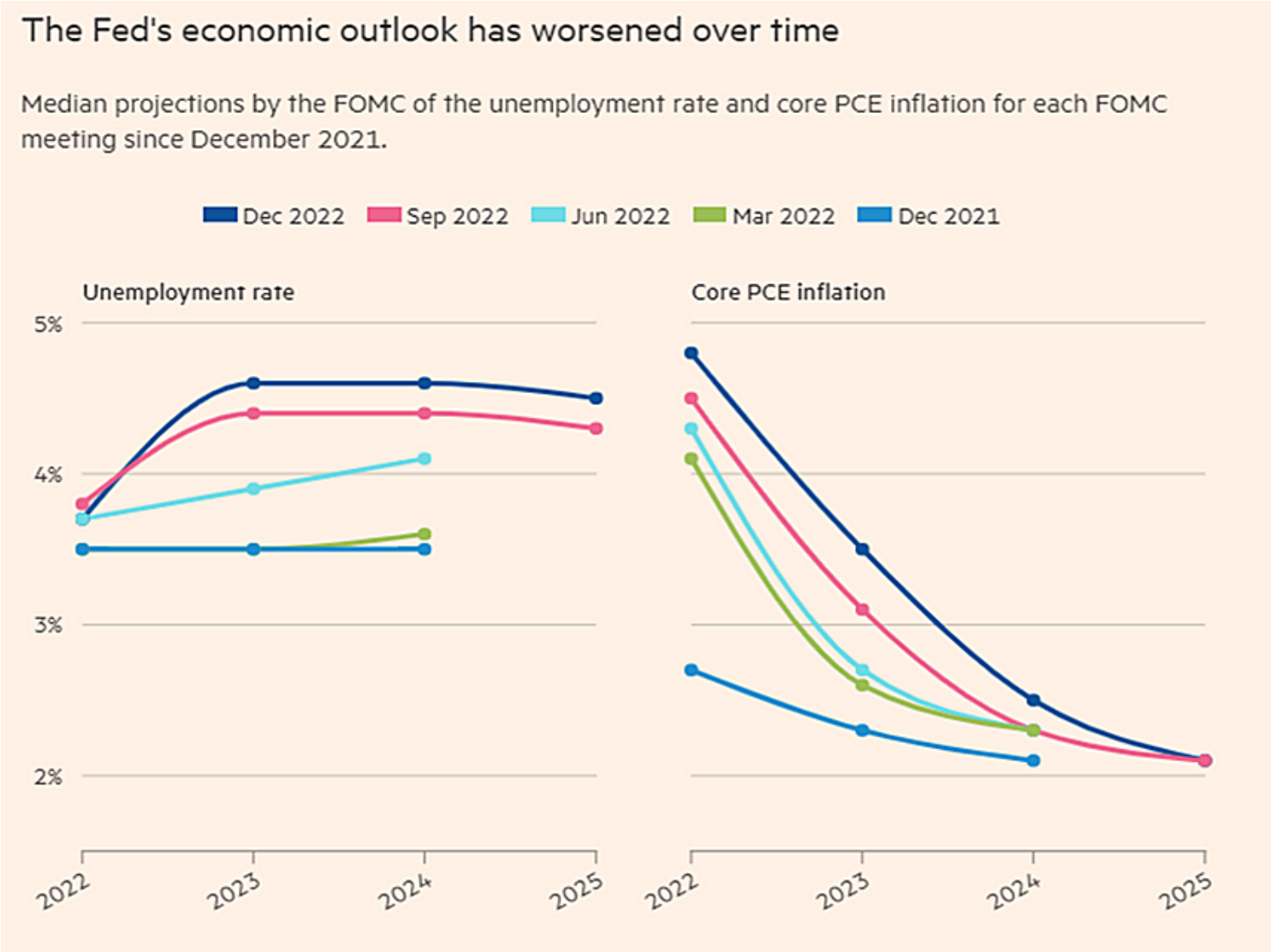
The December meeting of the Federal Reserve saw the central bank increase interest rates in the region to their highest level since 2007. This came in the form of a 50-basis point move to 4.25-4.50%, as was widely expected by market participants. In his post-meeting press conference, Fed Chair Jerome Powell stated: "We've covered a lot of ground and the full effects of our rapid tightening so far are yet to be felt. We have more work to do". He also welcomed the recent reductions seen in both CPI and PPI inflation but warned "it will take substantially more evidence to give confidence that inflation is on a sustained downward path."

In terms of the Fed's updated interest rate projections, the new median estimate is for the Fed Funds rate to end 2023 at 5.1%, up from the September forecast for a peak of 4.6%. Most policymakers at the central bank now expect rates to decline to 4.1% in 2024 and 3.1% the following year. This compares to the previous 3.9% and 2.9% forecasts, respectively. "I wouldn't see us considering rate cuts until the committee is confident that inflation is moving down to 2% in a sustained way – that's the test", said Powell. The Fed are scheduled to issue their first release of the year on February 1st, where most of the market currently expects a smaller 25bp move with a minority looking for another 50bp. Most investors then expect the US central bank to pause somewhere either side of the 5.00% mark.

"We've covered a lot of ground and the full effects of our rapid tightening so far are yet to be felt. We have more work to do."

Fed Chair Jerome Powell

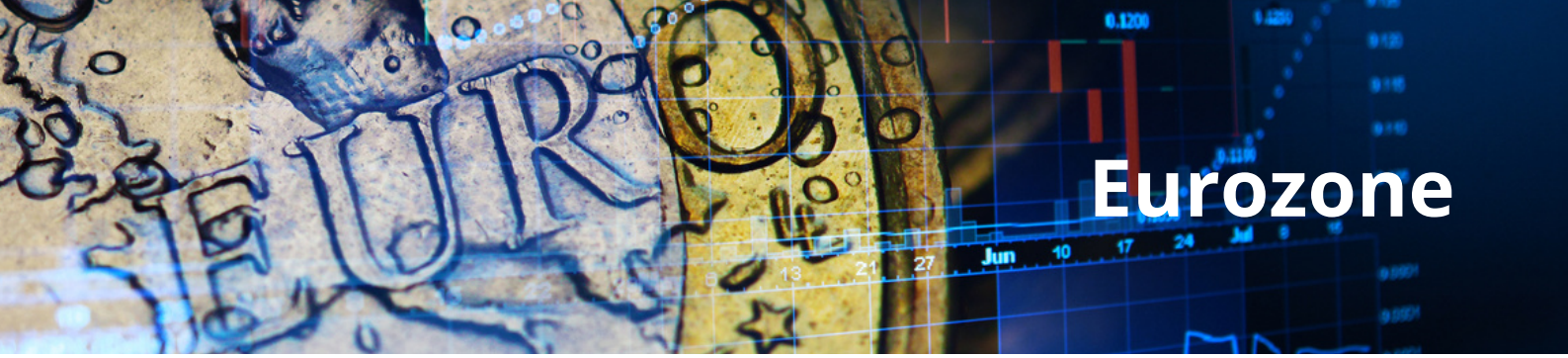
Policymakers also increased their forecasts for 2023 inflation, with the median estimate for the Core PCE index — seen at 3.5%, compared to the 3.1% forecast in September. In 2024, most officials anticipate it will have declined to 2.5%, still above the central bank's target. It is then forecast at 2.1% the following year. Policymakers were more downbeat on the outlook. The economy is set to grow just 0.5% this year before registering a 1.6% expansion in 2024 as the unemployment rate tops out at 4.6% (seen below). In September, most officials predicted economic growth of 1.2% for 2023 followed by a 1.7% increase in 2024, with the unemployment rate topping out at 4.4%.



Source: Federal Reserve, Financial Times

The Fed has now enacted 425bp worth of rate increases since it commenced its tightening cycle last March. It anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to its 2% target over time. In determining the pace of future increases, the Fed said it will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, as well as economic and financial developments.

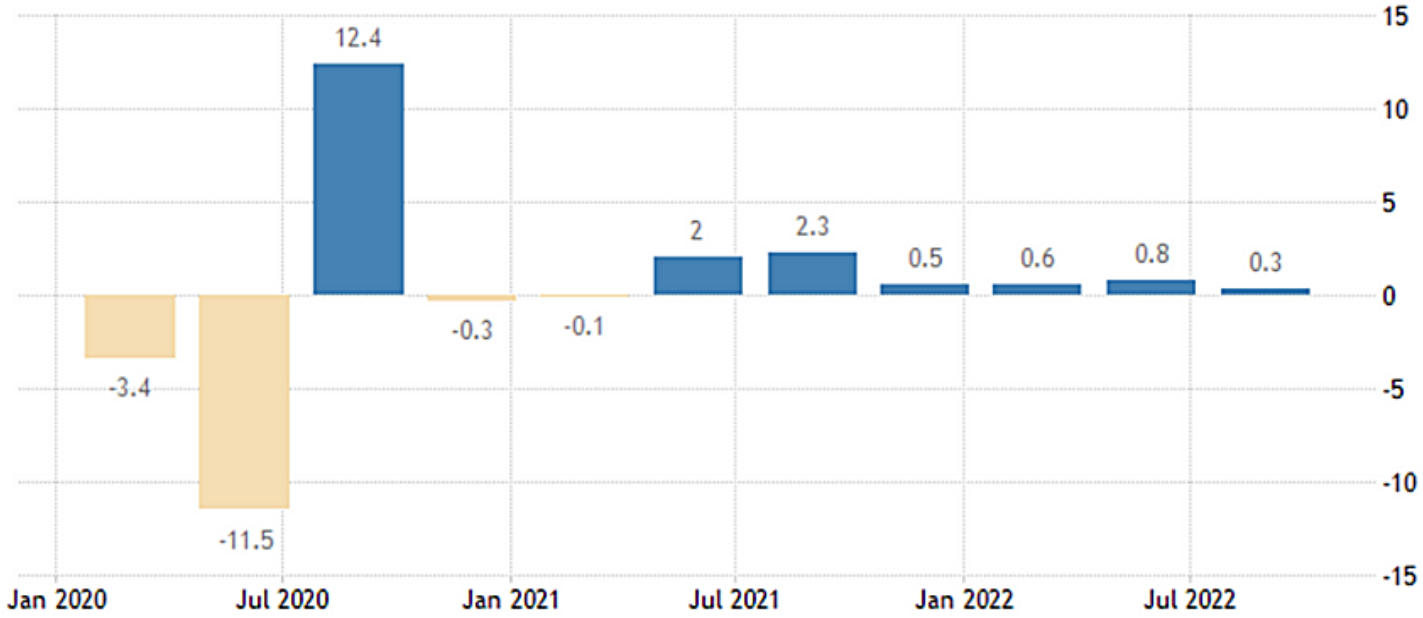
A Fed pivot at some stage in H2 2023 is probable in our view. It is still quite difficult to judge when we may see the central bank cutting rates again, but we must point out that for a proper Fed pivot to take place, we will first need to see a few things happen simultaneously. These will likely include a combination of economic deterioration, an uptick in unemployment, continued market volatility, decline in levels of risky assets, and most importantly a decline in inflation. All of these are likely to cause or coincide with downside risk in the near term, albeit with the continued low positioning in risk assets probably acting as a mitigating factor. Then, at some point in the second half of 2023, US markets will likely turn their focus towards the better economic prospects and corporate fundamentals later in 2024, and trade at levels higher than now.



Eurozone

The eurozone outlook has improved marginally, although as we have said, a recession still seems to be the most likely scenario early this year. These improvements have come from the success in filling gas storage ahead of the winter, the mostly mild weather seen so far, and the energy savings measures implemented within the industrial sector. It now seems that energy rationing will not be required and the previous fears of forced shutdowns of energy-intensive industries should not occur. So far, we think it can be said that the worst fears of the energy shock are not being realised. Economic sentiment and other leading indicators of economic health continued to pick back up during the month of December for the Euro area.Importantly, we saw the region's services PMI (Purchasing Managers' Index) beat expectations and come in at 49.8, almost back in expansionary territory for the first time in five months. Similarly, the manufacturing PMI increased to 47.8, having bounced from the 46.4 seen in October. On the price front, input cost inflation slowed to a 19-month low, but remained elevated by historical standards, while selling prices rose at the weakest pace in a year. Business confidence picked up to a four-month high but remained weaker than anything seen in the two years prior to July, amid recession risks, energy market concerns and high inflation.

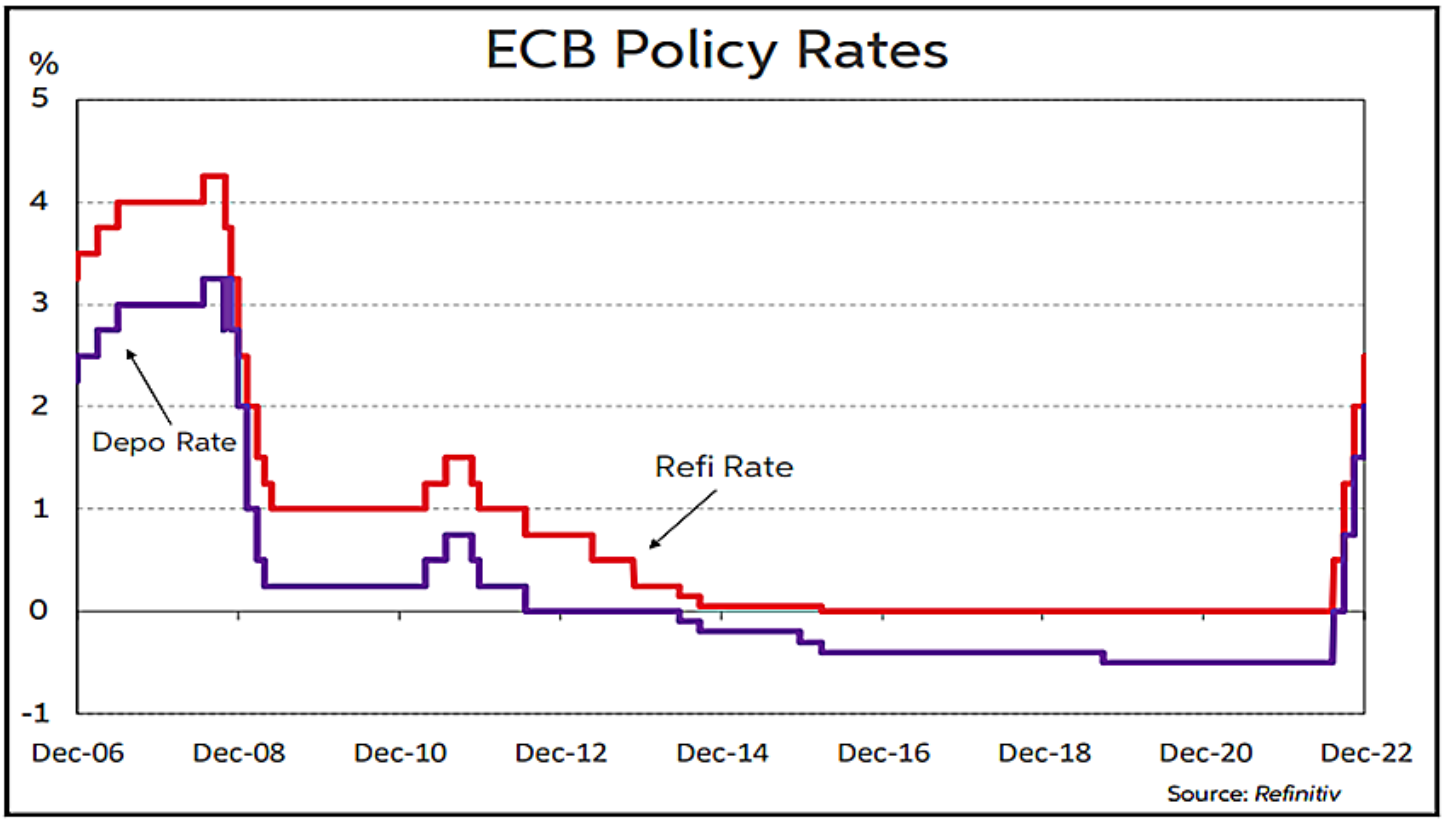
As can be seen below, Eurozone GDP expanded by 0.6% and 0.8% in the opening two quarters of 2022. However, the economy has lost considerable pace in the second half of the year, with GDP growth slowing to 0.3% in Q3. Fixed investment was the main driver of growth during the third quarter, rising by 3.6% quarter (vs 0.9% in Q2). In addition, household consumption advanced 0.9% (vs 1.0% in Q2) and government spending increased by a meager 0.1%. Activity appears to have slowed even further in Q4, with a contraction in GDP now expected by most.



Source: Tradingeconomics.com, Eurostat

Eurozone headline inflation for December dropped to 9.2% y/y, but came in at 5.2% y/y in core terms (up slightly on the prior month). We believe both figures should fall during 2023 as the region's economy weakens, with this outlook depending somewhat on energy prices stabilizing. Another surge in gas prices next year would see inflation remain high and could pose the risk of an extended recession. More ECB tightening seems likely given the very tight labor market - the unemployment rate, at 6.5%, is the lowest since the launch of the common currency. This pressure from the central bank will feed through to the real economy over the course of this year.

In December the European Central Bank raised its main interest rates for the fourth consecutive time, opting to go for a smaller 50-basis point move after what were two 75bp hikes in a row over recent months. ECB President Christine Lagarde was more hawkish-sounding last month and stressed the fact that rates in Europe may well need to move higher than the previously expected 3%. It is clear that the ECB are very uncomfortable with current levels of inflation and now believe more will need to be done in terms of rate hikes. As was widely expected, the central bank also laid out plans to reverse years of asset purchases. They are now set to reduce monthly reinvestments from the APP (Asset Purchase Programme) by €15 billion starting in March and will revise the pace of balance sheet reduction in July.

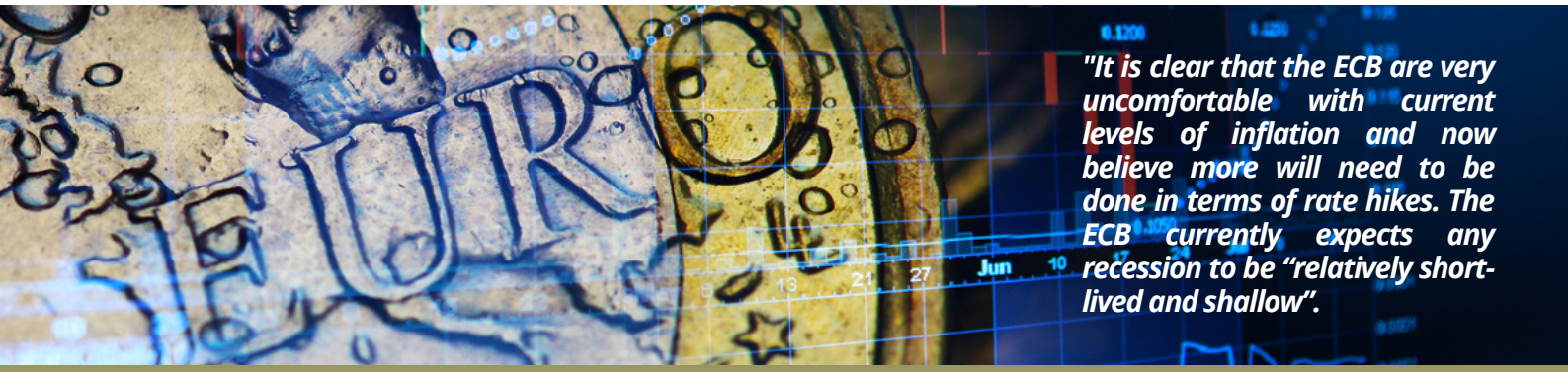


Source: Refinitiv, AIB

Interestingly, and despite clearly voicing their concerns about persistent inflation, the statement said that the ECB currently expects any recession to be "relatively short-lived and shallow". In terms of updated economic projections, inflation expectations were increased and it is now seen at an average of 6.3% next year (vs the prior 5.5%) and 3.4% (vs prior 2.3%). Even by 2025, the ECB still only sees inflation getting down to 2.3%. Initially driven by excess money in the system and Covid-related supply chain issues, Eurozone inflation has stayed high this year on the back of soaring energy prices. However, food and services costs have become increasingly prominent over recent months, meaning inflation is now far more broad-based across the economy. The ECB now forecasts for GDP growth to come in at just 0.5% in 2023, compared with their estimates for 0.9% jut three months ago. In 2024 and 2025 it is forecasting for 1.9% and 1.8% growth.

The ECB is not in any way done yet, and the move to a smaller rate hike should not be taken as a sign of an imminent end to its hiking cycle. Indeed, in a clearly hawkish signal, officials warned that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% target. They also added that keeping interest rates at restrictive levels will over time reduce inflation by dampening demand, a clear nod not to expect any early reversal of policy. The ECB repeated that inflation remains far too high and is likely to stay above target for an extended period of time. It also noted that price pressures have broadened across the economy.

President Lagarde acknowledged, though, that the Eurozone now faces a short, shallow recession. Growth was stronger than expected in the first half of the year, but the economy is now clearly losing momentum. The ECB sees GDP contracting in Q4 2022 and again in Q1 2023. It lowered its 2023 GDP growth forecast to 0.5% from the 0.9% contained in its September macro projections. It still sees the economy recovering appreciably in 2024-5 with the growth predictions virtually unchanged at circa 1.9% in both years.



"It is clear that the ECB are very uncomfortable with current levels of inflation and now believe more will need to be done in terms of rate hikes. The ECB currently expects any recession to be "relatively short-lived and shallow".

United Kingdom

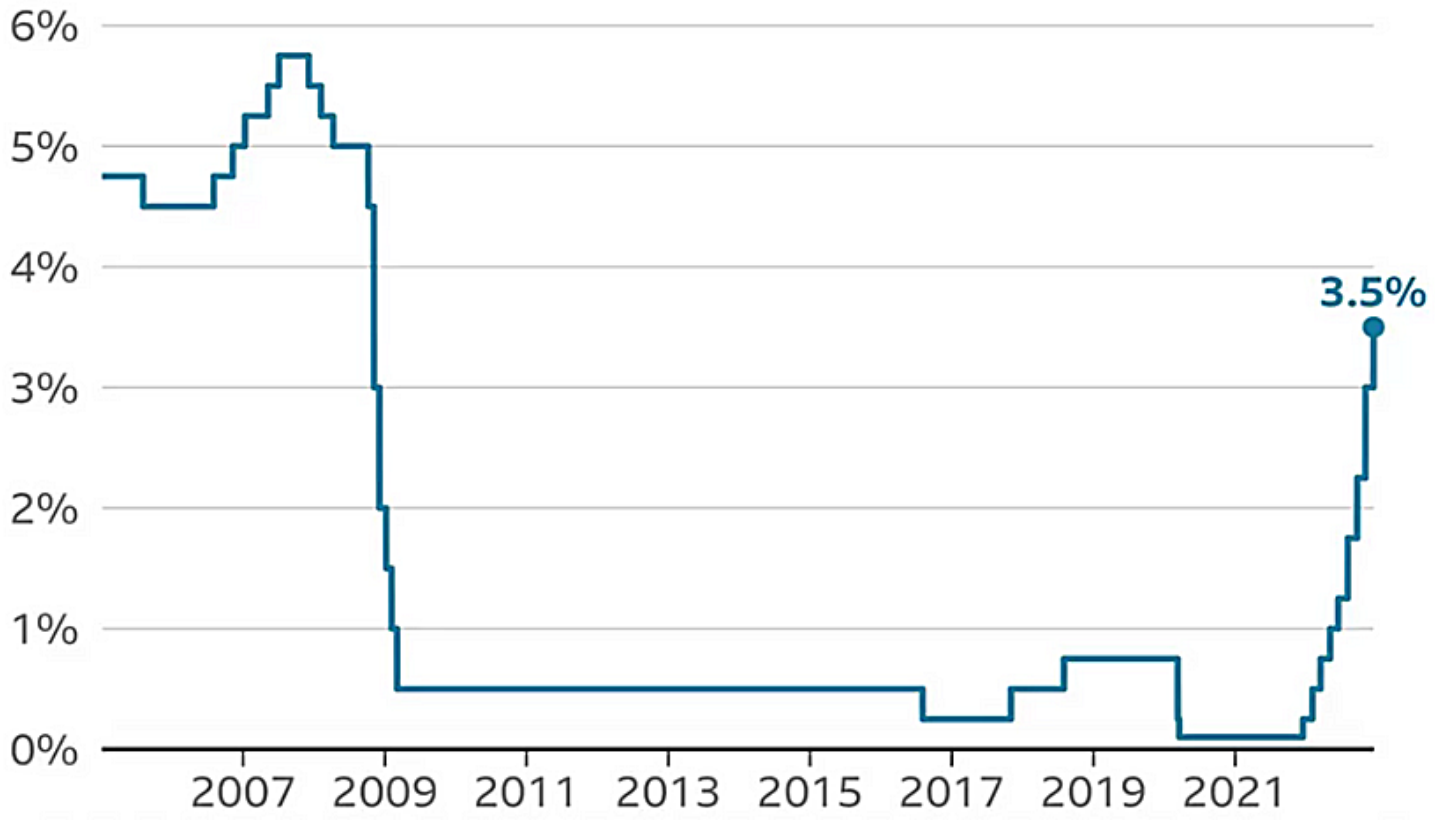
The UK seems set for a prolonged recession, as monetary tightening, fiscal tightening, the energy price shock, and supply-side constraints from Brexit combine to create a challenging outlook. GDP has yet to regain pre-pandemic levels, but labour-supply shortages have driven the unemployment rate to the lowest level since 1973 just a few months ago. New prime minister Rishi Sunak has reversed the tax cuts introduced by the short-lived Truss government and in fact added on some tax increases. This has brought some much-needed calm to the nation's bond market and has reduced the upward pressure on mortgage rates. Markets expect the Bank of England (BOE) to lift the base rate from 3.5% currently to 4.5% by the second quarter of this year, as wage pressures prevent inflation from falling quickly in the region. It is questionable however whether the BOE will be able to raise rates by this much given the direction of the UK economy.

Growth of around 4% in 2022 may turn out to be mathematically correct for the United Kingdom, but we believe this figure to be misleading, reflecting their rebound in activity amid a post-pandemic reopening. The likelihood of a significant economic decline in 2023 – which has continuously been revised lower in recent months – is indeed a much more accurate reflection of the truth for the UK. It is undeniable that the energy price shock of 2022 has been having a considerably negative impact on real incomes for British households, restricting discretionary spending. They are also being hurt by higher interest rates (especially for mortgages) and are likely, along with many other regions, to face the additional pain of rising unemployment next year.

Having expanded by 0.6% and 0.1% in Q1 and Q2, respectively, UK GDP contracted by 0.3% in the third quarter. However, this figure was negatively affected by a bank holiday to mark the Queen's funeral in September. As we alluded to in our recent Interim Investment Update, and as up-to-date survey data for Q4 suggests, the UK economy is entering or is already in a recession. The region's December Manufacturing PMI came in at a fresh three-year low of 45.3, having now stayed in contractionary territory for five consecutive months. Similarly, the Services PMI fell below the key 50 threshold to 48.8 in October and has since only picked up marginally. Consumer confidence is very weak also, at –42 in December, close to its all-time low of –49 from September.

While the Bank of England did not issue updated projections at its meeting last month, it did so at its previous meeting in November. These forecasts are for a decline of 0.1% in GDP in the final quarter of 2022, and for inflation to remain elevated in 2023, running at 5.2% by the end of the year and falling to 1.4% by Q4 2024. Despite the region's unemployment rate edging higher to 3.7% in the three months to October, conditions in the labour market remain very tight. There are now roughly 300k fewer people in employment, and 413K less in the labour force than before the pandemic struck. Overall, the UK economy is facing a number of significant headwinds. The cost-of-living squeeze, due to higher inflation is weighing heavily on real incomes. Tighter monetary policy is also having an impact. The Bank of England's final monetary policy meeting of 2022 saw the bank hike by 50bp, in line with the other major central banks around the globe. This move was in line with market expectations, brings the Bank rate up to 3.5%, and marks the ninth consecutive meeting where the BOE has raised rates.

United Kingdom



Source: BBC, Bank of England

As can be seen on the above chart, The BOE has now hiked rates by a total of 340bp since it kicked off its current tightening cycle over one year ago. However, the voting breakdown last month showed that the voting committee was split on its rate decision. Six members were in favour of the 50bp hike - of the view that conditions in the labour market remained tight and that there was evidence of upward pressures on both prices and wages in the domestic economy. Two members preferred to maintain rates at 3%, on the basis that the real economy remained weak, increasing signs that the downturn was starting to affect the labour market, as well as the fact that lag effects of previous rate hikes had still to come through. Finally, one member voted for a 75bps increase, noting that there were greater signs that price and wage pressures would “stay strong for longer” than had been assumed in November.

China

In 2023 we are set to see the Chinese economy eventually exit its unusual and harsh zero-Covid government rules, after having spent most of 2022 under intense restrictions and rolling lockdowns in different areas of the country. Recent government announcements show that plans to ease restrictions are indeed now being made, but some restrictions are likely to remain in place throughout the winter. Another key theme for China in 2023 will of course be its struggling property market. The government has announced support measures over the course of the last year, but they do not appear large enough in our view to support a sustained recovery. We expect more measures to improve confidence in the housing sector and to boost spending when the economy fully re-opens. Retail sales are running well below previous trends, driven by the tough restrictions and by low consumer confidence. Attention should also be paid to any further government announcements around investment in semiconductors following the actions by the US government to limit the export of chips to China.

Chinese equities — which have been heavily sold due to the economic fallout from the Covid outbreaks — rebounded strongly as 2022 drew to a close, buoyed by the promise of kinder, gentler policies to come. Equities in the region still look cheap from a longer-term point of view. We believe that when they do fully emerge from the restrictions, this will help unleash pent-up consumer demand, powering further gains for Chinese stocks and likely providing a boost for the global economy as well. Weak demand that kept Core CPI under 1% may reverse upon reopening, keeping the People's Bank of China from easing policy to support growth. The Chinese yuan should be under downward pressure as G10 central banks deliver their final hikes, and it will probably adjust to somewhere in the region of 7.50 per dollar.

Equities

Following on from a highly turbulent and negative 2022, 2023 will be extremely interesting to say the least. The outlook for equity markets over the next 12 months will be dependent on a number of factors including changes in monetary policy, slowing global growth, inflation, corporate earnings, and geopolitical matters such as the evolution of the Russia-Ukraine crisis. Equities have declined over the last twelve months as central banks have tightened policy, bond yields have risen, and growth forecasts have fallen. Post the falls, the S&P 500 now looks more attractive on an absolute valuation basis, currently trading on a 12-month forward price-to-earnings multiple of 16.6x, back at its 25-year average.

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.65x	16.82x	-0.05
CAPE	Shiller's P/E	27.96x	27.93x	0.01
Div. Yield	Dividend yield	1.81%	1.99%	0.53
P/B	Price to book	3.42x	3.10x	0.40
P/CF	Price to cash flow	12.42x	11.19x	0.56
EY Spread	EY minus Baa yield	0.17%	0.27%	0.05

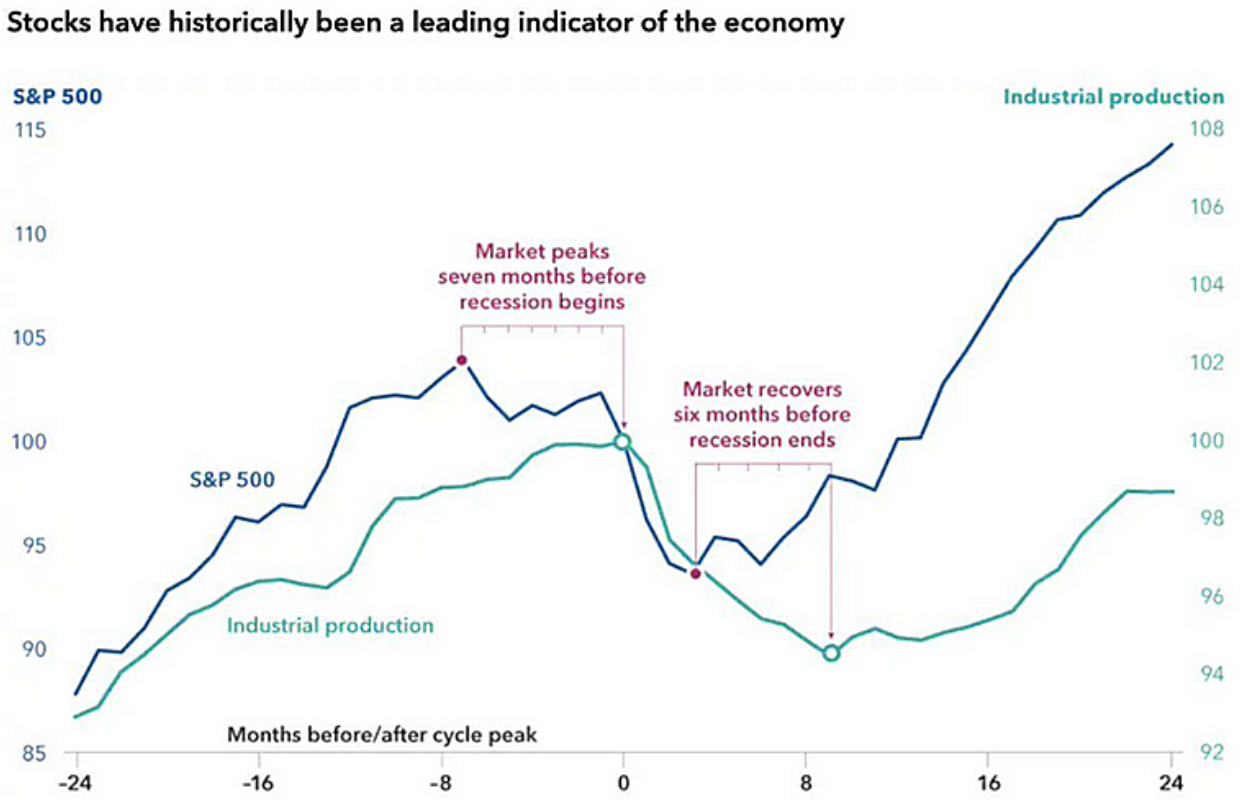
Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, JP Morgan Asset Management.

Equities, contd.....

As we enter a new year, our house view on equity markets remains the same from our most recent publication in early-December. We would like to reiterate that we currently have a neutral stance on developed market equities in the near-term. Beyond this, we will at some point look to take advantage if we see a further pullback in prices over the coming months, similar to what we witnessed in early October. As we have mentioned before, we may see central banks overtighten in 2023 and then subsequently have to make a dovish pivot, which would also give us a valid longer-term 'buy' signal.

In the near-term, however, the asset class may have headwinds and further volatility. We will be actively monitoring pricing opportunities to create structured investment solutions for investors who can view medium/long term time horizons... to focus on enduring trends across investment themes for the long run, including energy transition, circular economy, environmental sustainability (ESG), climate change and technology.

Many equity analysts are calling for downgrades on earnings, noting that consensus earnings estimates for the fourth quarter are currently too high. While in the medium and longer-term we believe the growth equity factor will come back into favour, investors over the next six months may be better placed in higher yielding, more defensive parts of market. These include energy and financials, and bond proxies such as consumer staples, healthcare and utilities. Energy could continue to outperform at the start of this year, especially given our view on oil prices moving slightly higher in 2023. Typically, we would avoid financials during recessionary times, however companies have evolved since the financial crisis of 2007-08 and the sector in general is now well-capitalised, healthier, and has fairly stable earnings growth.

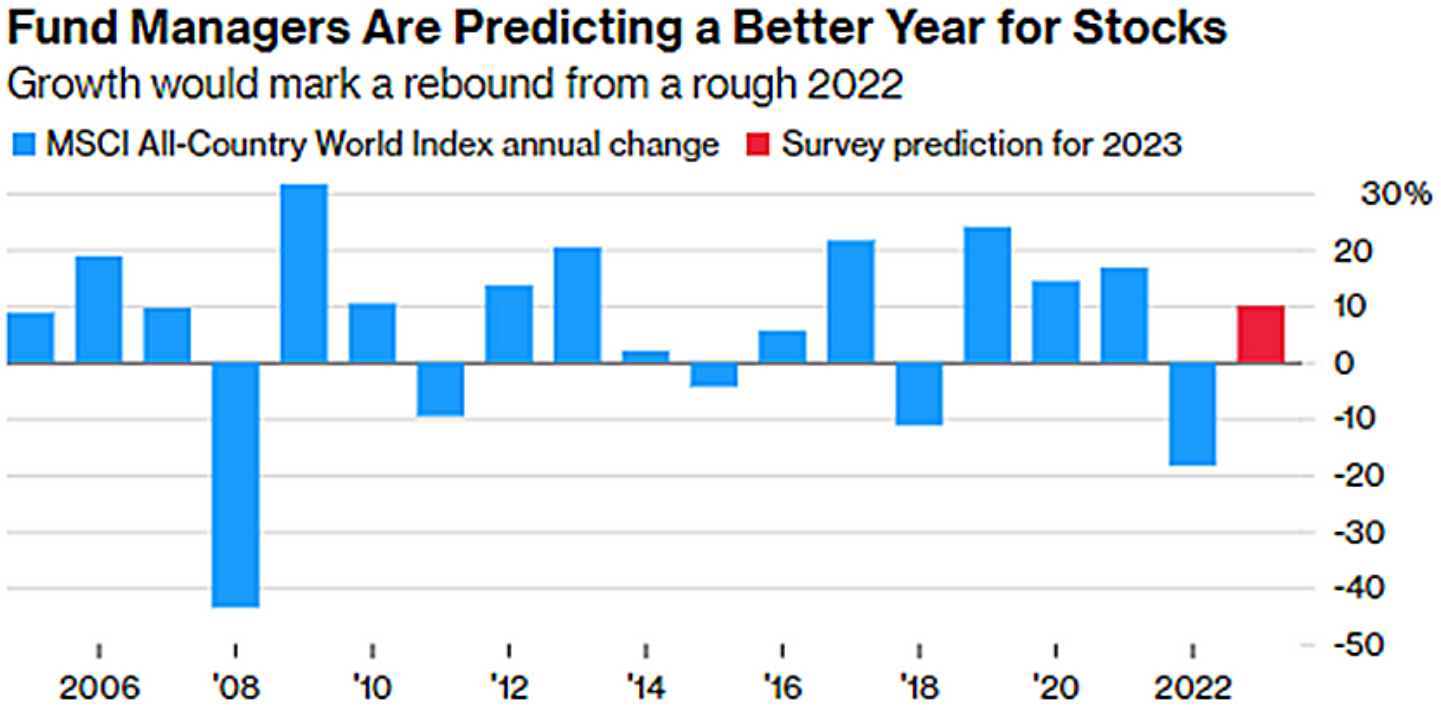


Source: Capital Group, Seeking Alpha

The chart above serves as a useful reminder that stocks have historically been a leading indicator of the economy, not the other way around. On average, the S&P 500 index tends to peak seven months before recessions begin and usually recovers six months before they end. Equity markets peaked in January of 2022 - twelve months on from that point, it is very important in our view to keep these statistics in mind. Stocks will likely bottom and begin their recovery long before a recession has ended this year or possibly early next. This further reinforces our aim to move back towards an overweight positioning in equities at some point later this year if and when the opportunity presents itself.

Equities, contd.....

Further positive predictions come from a survey carried out by Bloomberg in early-December, which involved 134 of the world's largest fund managers and investment banks. Interestingly, many of these market participants predicted that global stock markets will see low double-digit gains next year. The survey showed that 71% of respondents expected the asset class to see gains, versus 19% forecasting declines and 10% for no change. For those seeing gains, the average response was for +10%, and most saw gains skewed towards the second half of the year. However, markets could still be temporarily derailed again by sticky core inflation, or a deeper than expected recession. These were the top two concerns for the upcoming year amongst those surveyed. Aside from these risks, we acknowledge that earnings are at risk of being downgraded or outright missing analysts' expectations due to slower top-line growth in a slowing growth environment, margin pressures from higher input and labour costs, and a recession-related weakness in consumer demand for goods and services.



Source: Bloomberg

It is also worth pointing out at this juncture that consecutive down years are extremely rare for stocks, so after last year's drop, there is only a low probability that they will post annual declines again in 2023. For example, since World War 2, the S&P 500 has only fallen for two straight years on three occasions: in 1947, 1974 during the oil crisis, and then the bursting of the dot-com bubble at the start of this century. We would also add that in 1947 the index lost just 2.5% in its second consecutive down-year. Apart from this, in every other instance since the 1940s we have seen red years preceded by a green year. While we acknowledge that history is only a guide and should be used alongside other factors, such as the business cycle and fundamentals, this still gives us some perspective and highlights the low likelihood that equities will see another year of losses in 2023.

Despite having bounced during the final months of 2022, the iShares MSCI Emerging Markets ETF benchmark has traded down by over 22% in 2022 and has in fact been range-bound for most of the past decade. We believe 2023 may finally be the year where these regions outperform developed markets and believe they would act as a strong portfolio diversifier, as satellite funds. We are of the view that recessions in the West will allow Asia in particular to outperform as stocks there offer cheaper valuations and a better fundamental outlook. Beijing's shift away from its zero-Covid policy has also improved the outlook for equities in the broad area.

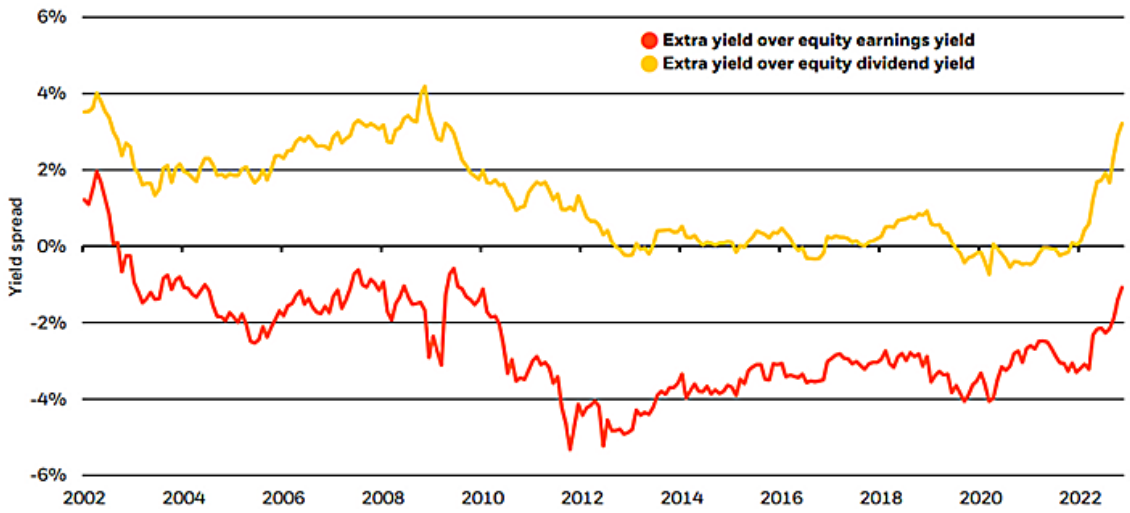
Valuations are clearly reasonable, and we see cyclical winds shifting in favor of Emerging Markets (EM) should we see global inflation ease more rapidly than expected this year, central banks pause rate hikes, and a dollar decline. The US dollar's bull run has likely been exhausted and, once it has convincingly changed direction, should brighten the relative outlook for EM risk assets. In addition, the downturn in the earnings cycle in EM is already more mature than developed market equities.

Fixed Income

As we move into 2023, we believe at Seaspray that it is time to reassess the bond market after an extremely negative 2022 with significant price falls and the sharp rise in yields. We see higher yields as a gift to investors long starved of a real income in this space, and we also don't need to go far up the fixed income risk spectrum to receive it. We prefer investment grade (IG) credit and inflation-linked bonds. With regard to government bonds, we are opting to stay underweight longer-duration. We prefer short-term government bonds for income, believing that the jump in yields last year has reduced the need to take risk by seeking yield further out the curve. The risk of a further significant selloff for sovereign debt seems limited given inflation is close to peaking and markets have already priced hawkish outlooks for most central banks.

For corporate debt, higher yields and still-robust balance sheets in most sectors suggest to us investment grade credit may be better placed than equities to weather a recession during H1. Below we can see that investment grade yield, relative to earnings and equity dividend yield, is now attractive and especially so on a risk-adjusted basis. This supports our constructive view on IG credit for 2023. One potential risk for corporate bonds is that spreads may come under some upward pressure if US recession probabilities increase and there are fears of rising defaults.

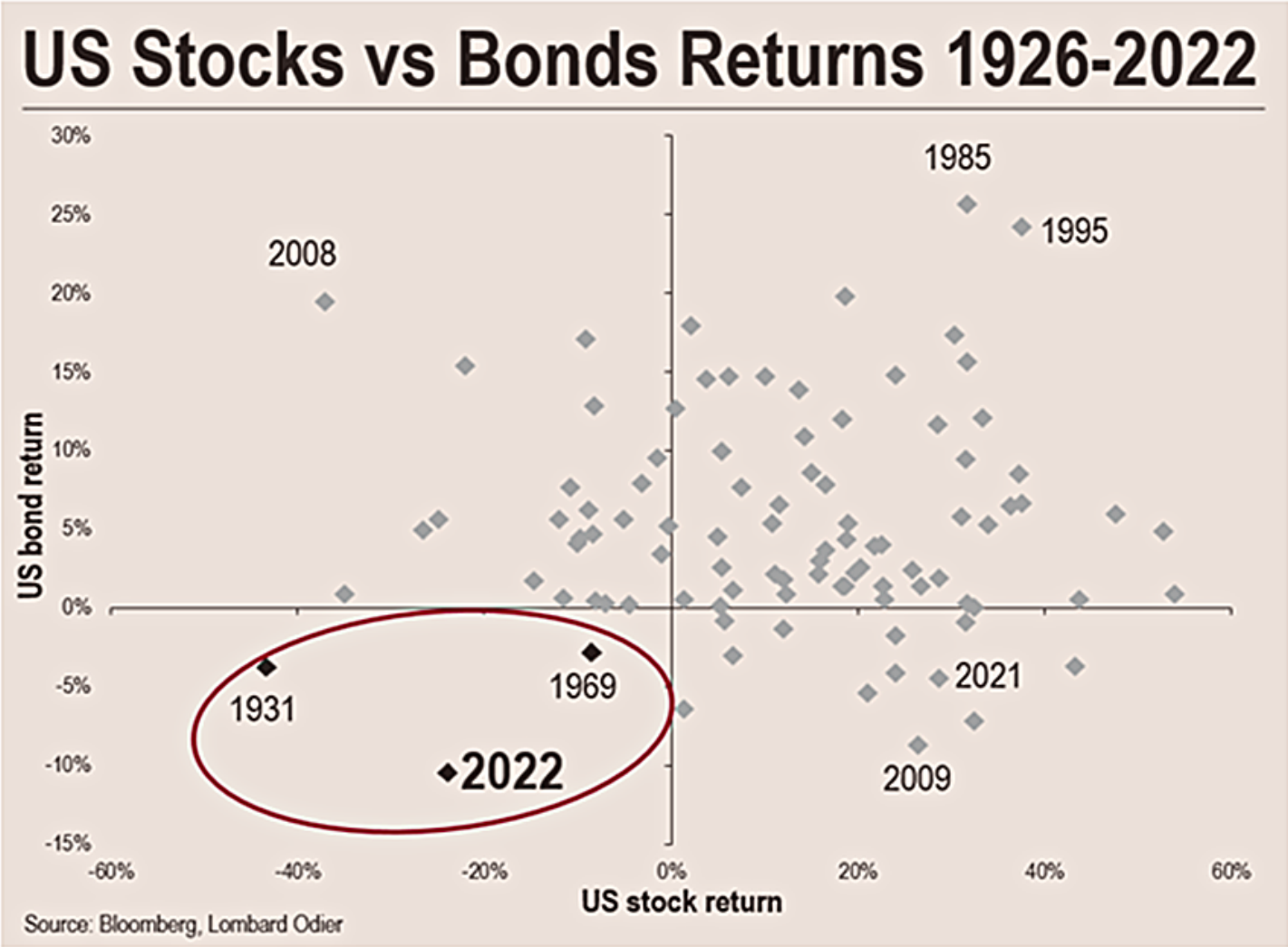
Global investment grade credit yield vs. equity yields, 2000-2022



Source: BlackRock Investment Institute, Refinitiv Datastream

Fixed Income, contd...

Between recessions and other risks, 2023, especially H1, could indeed be challenging in an economic sense. Asset markets are forward-looking however and have moved to price in most if not all of this concern and as a result valuations are now more realistic. This is certainly the case in fixed income markets. Last year was brutal for fixed income with yields rising sharply. The good news about this move is that the higher yield levels are now offering attractive opportunities for balanced portfolio construction. Later in the year we see a relatively strong likelihood that market attention begins to shift away from inflation and instead toward levels of economic growth. In the past, when we have had 'growth scares', fixed income has outperformed and thus should regain its 'safe haven' status in 2023.

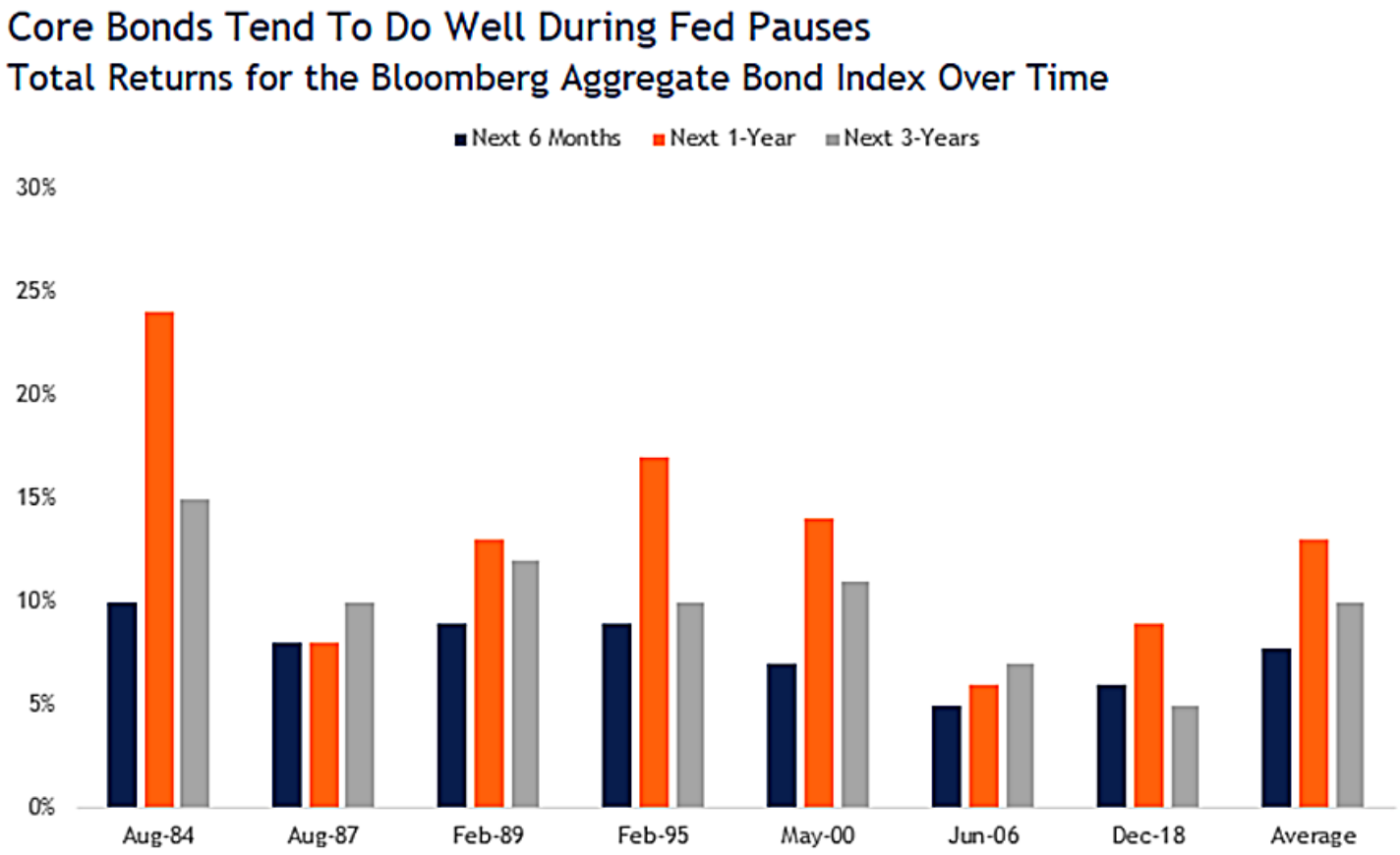


Source: Bloomberg, Lombard Odier

2022 was undoubtedly an extreme year when it came to the positive correlation between stocks and bonds. Since 1926, the two asset classes in the US have had just three years of combined negative return (1931, 1969, and now 2022). This is illustrated on the graph above, with US bond returns are on the left-hand side of the chart below and US stocks returns are at the bottom on the X-axis. Clearly this phenomenon is very unusual. In our view, it is highly unlikely that this repeats in 2023. The question now for investors – which asset class will bounce back, if not both.

Fixed Income, contd...

Historically, the bond market has performed well during Fed rate hike pauses. Since 1984, core bonds were able to generate average 6-month and 1-year returns of 8% and 13%, respectively, after the Fed stopped raising rates. Moreover, all periods generated positive returns over the 6-month, 1-year and 3-year horizons.



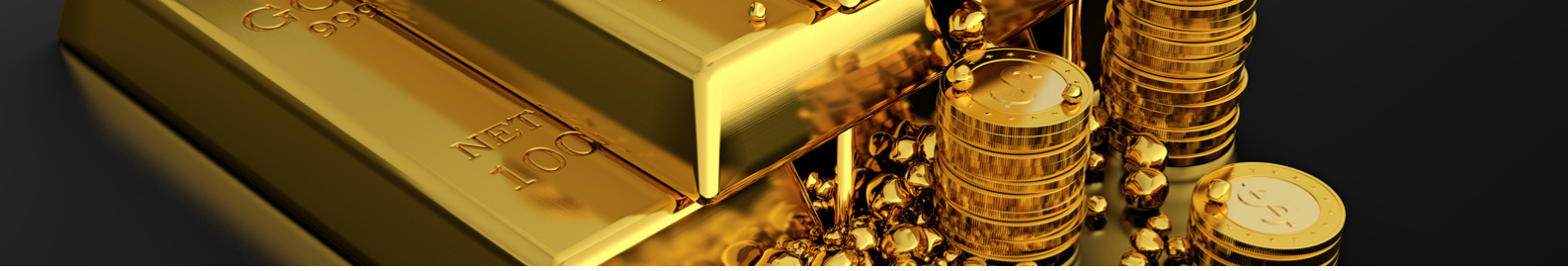
Source: LPL Research, Bloomberg

Currencies

The US dollar rallied sharply in 2022 before paring some of these gains during the fourth quarter. Q1 – Q3 of last year saw increasing Fed hawkishness underpin the world's reserve currency, along with its perceived safe-haven appeal during the Russian-Ukraine conflict. We believe the greenback could weaken if US inflation continues to decline over the coming months and the Fed pivots to a less hawkish stance at some stage in Q1. As it stands, the main beneficiaries are likely to be the euro, the British pound and the Japanese yen. Our expectation of modest dollar weakness also reflects several other factors, such as a gaping US current account deficit and incredibly stretched valuations for the dollar, which just a few months ago reached multi-decade highs.

While there is likely some upside in store for both euro and sterling against the dollar, much will depend on prevailing energy price dynamics for these two currencies. Overall, investors should get set for a longer-term phase of dollar weakness, which is set to follow what has been an incredible run for the greenback over the last few years. Lower inflation in the Eurozone and UK should also encourage a less hawkish ECB and BOE. In our view, this should help growth expectations rebound in these vicinities as rates fall, which in theory would result in euro and sterling strength.

Once the global economy likely begins to recover later this year, commodity currencies (such as the Canadian and Australian dollar's) and currencies that are highly sensitive to global growth should also begin to outperform vs USD. Although the outlook for emerging market currencies is rather mixed as we enter 2023, we think that the Brazilian real and the Mexican peso will benefit significantly given their materially higher interest rate profiles. Emerging markets that have US dollar debt will also see their debt-GDP ratios fall as their currencies rise, further helping to decrease borrowing costs and in-turn boosting growth. In a nutshell, we see the negative feedback loops that were in place in 2022 reversing, at least somewhat in 2023 led by lower US inflation, lower US interest rates, and a weaker US dollar.



Commodities & Real Assets

Real-estate investment trusts (REITs) look attractively valued relative to global equities and listed infrastructure, and they should benefit from declining bond yields as the year goes on. The commodities outlook is mixed however, given the current slowdown in the global economy. A post-lockdown gain in construction activity in China this year will support demand for industrial metals, but the outlook for precious metals is less clear. The energy market outlook is complex. Recessions will reduce oil demand, but the supply side may tighten if more restrictions are placed on Russian oil exports.

Gold defied consensus expectations over the past 12 months as it struggled to rise, despite high inflation pressures and significant geopolitical tensions. There were two main reasons for gold's disappointing performance. Firstly, higher interest rates pushed up longer-term real rate expectations, with which gold has a longstanding inverse relationship because of the opportunity cost of holding gold. So as real rates have risen throughout 2022, this has put downside pressure on the gold price. Secondly, medium and longer-term inflation expectations have drifted lower throughout the year, reflecting investors' belief that rate hikes and slowing growth will restrict inflation. Gold's disappointing performance has led investors to reduce allocations steadily during the year, further weighing on the price. Coming into 2023, we anticipate that the gold price will rise slowly. We think that US real rate expectations have peaked, and as they decline gradually, this will result in some upside pressure on the precious metal. This trend will also benefit from any dollar weakness.

Oil prices have continued to fall into the end of 2022 after a strong start to the year. An initial spike in prices, following the invasion of Ukraine by Russia, has now more than eroded away. Russian oil is still making its way into the market via India and China, global monetary tightening across most of the global economy is threatening growth, as well as the zero-Covid policy seen in China during 2022 also impacting economic activity and in turn demand-side assumptions. While the Organisation of Petroleum Exporting Countries (OPEC) and its Russian-led allies (OPEC+) have tried to balance markets through changes in supply, the strategic release of oil reserves from the US and the International Energy Agency (IEA), as well as price capping on Russian crude has helped ease prices.

Total supply increases of oil in 2023 are expected to fall short of demand-side growth as economies recover, albeit marginally. This suggests a gentle uplift in prices from current levels of around $83 per barrel in the case of Brent Crude and $78 for the American WTI Crude. The major upside 'risks' to oil prices come in the form of escalating geopolitical tensions, and also the possibility of a faster than expected economic recovery in China (should covid policy see a swift, full, and permanent relaxation).

Markets have been pricing in a slowing rate of growth in the global economy which oil prices partially reflect already. Downside risks also remain should slowing growth in the US move to a recession, and what appears a likely recession in parts of Europe become prolonged. However, OPEC+ have been quick in the past to counter the threat of fading demand through supply curbs, which would be a likely counter again moving forward should a hard economic landing be realised. One possible but unlikely factor that would lead to a sharp fall in crude pricing, would be if there was a de-escalation of conflicts in Ukraine. This would suggest that a flurry of supply might eventually be allowed back into the broader marketplace.

Making Waves Podcast Series

We are delighted to announce the launch of our new 'Making Waves' podcast series and the inaugural podcast covering this 2023 Investment Outlook, is available for you to **view /listen here** and at the link below. We hope you enjoy and gain some valuable insight from the discussion.

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