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Nikko Asset Management

2023 Global equity outlook

Navigating the new road ahead

By the Global Equity Team
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The months of November and December are all about expectations management in most family homes in the UK, as (occasionally unrealistic) children's expectations for Christmas presents come into conflict with the economic realities of family budgets. It is little different in global equity markets—particularly in 2022.

Investors are hoping for a seasonal gift from Federal Reserve (Fed) Chair Jerome Powell and his colleagues in the Policy Committee. A pivot away from the rapid pace of monetary tightening would be high on the Christmas wish list for many after a punishing 2022. With cash balances high, according to fund manager positioning surveys—any such change of tone by the Fed would likely release a substantial rally in equity markets.

As ever, however, it pays to be realistic and Powell certainly set a fairly cautious tone at his month-end press conference. He talked repeatedly of the need for rates to potentially go higher than he had previously expected (and stay there) for longer. Why did anyone expect anything else? The Fed is clearly determined to establish its inflation-fighting credibility after years of being challenged by markets. It has certainly not been obvious who is leading who in recent years, with periods of equity and credit market volatility often appearing to steer monetary policy, rather than the opposite.

Policy makers probably don't enter that job to be popular, but the current incumbents have certainly not been courting popular opinion in recent months. The Fed has been engaged in almost unprecedentedly fast monetary tightening in recent months, to put the inflation "genie" back in the bottle (we'll not devote any time here to considering the Fed's own role in creating that genie). During this process, interest rate hikes (and expectations of more to come) have lifted US mortgage rates above 7%. These levels have not been seen for more than 20 years (well beyond the career horizons of many equity market participants). In the process, the monthly service cost of a US mortgage has risen 50%, relative to the same time last year. This increased cost of living (along with higher energy costs) will doubtless weigh on consumption over time.

The cost of the change in monetary policy regime is not only being felt by US consumers, however. The value of the US government bonds that the Fed bought so aggressively during the years of quantitative easing have been falling sharply too. Although the losses on these purchases are only accounting entries at this stage, they are significant—running into hundreds of billions of US dollars.

Having invested so much in getting to the point where financial conditions may finally be having some impact on economic activity (and investors' approach to risk), why would the Fed make any explicit announcement, sounding the all clear and encouraging a return to the exact set of conditions that they are trying to change? Instead, it seems more likely to us that any shift in approach will be far more nuanced when it does come. It will be at least as important to watch what the Fed are doing as what they are saying.

We believe that we are probably past the period of peak inflation and near the point of peak hawkishness on monetary policy. What happens next, however, and what will not? It will hopefully surprise none of our clients that we think that we have high conviction around one thing that will not happen—that is a quick return to the policy (or economic) conditions that have characterized much of the last 20 years. The cost of raising capital is expected to prove higher for longer and the impact of this will likely be felt for years to come—even after the Fed stops hiking rates. Similarly, the investor positioning that has accumulated over the years of loose monetary policy will take some time to reflect this new reality. Our sense is that a lot of people still expect a quick return to the familiar themes that have proven

popular (and profitable) over the last few years. The derating of the technology and communication services sectors likely has more to go as these views are challenged.

It is often difficult to separate what we need from what we want. Our view is that what the world needs will inform investment spending in the coming years—rather than what we want. We are continuing to position for this via increased exposure to structural requirements, such as cheaper energy and affordable healthcare.

In conclusion, 2022 has been a punishing year for equity investors and investor expectations continue to be dampened by macroeconomic risks, from potential Fed policy error to an escalation of the conflict in Ukraine. Some of the factors that have shaped 2022 look less likely to recur in 2023 (for instance, supply chain duress because of COVID containment) but others will likely last longer (most notably a higher cost of capital, even if peak US interest rates are in sight). We are cautiously optimistic that less aggressive monetary policy will eventually make 2023 a kinder year for equity markets but there may yet be shocks to overcome.

Against such an uncertain background, we are continuing to focus on Future Quality companies with proven cash generation and where their valuations look attractive even if the equity risk premium remains elevated. Some of these companies have not been in the vanguard of market leadership over the last decade or so but history tells us that this is a positive. Market leadership post a bear market (like the one in 2022) is very rarely the same as that leading into it.

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