W1 | Marlborough Group

January 2023

Outlook: three key themes for 2023

In 2022 we experienced one of the most challenging years for investors since the Global Financial Crisis. Investors and consumers have been in a fistfight with inflation. We have endured runaway costs in everything from energy and food prices to holidays and building materials. As a reminder, inflation reached a four-decade high in 2022. Moreover, bond markets witnessed one of their worst years since records began. We have all felt the impact of inflation to some extent or another, and have the scars to prove it.

So, what lies ahead for 2023? In our outlook, we highlight three key themes for 2023 and offer answers to some of the questions your clients may ask.

Nathan Sweeney, Deputy Chief Investment Officer of Multi-Asset

1. Inflation

We have seen inflation at a 40-year high in 2022. Do you expect this to continue in 2023?

We expect inflation to fall in 2023. To a large extent, inflation has been driven higher by supply-chain disruption. The effects of the pandemic resulted in severe staff and product shortages when things finally reopened. If you have tried to go on holiday, you may have witnessed this first-hand, with staff shortages causing significant delays. In addition, higher energy prices pushed inflation to extreme levels not seen in decades. However, inflation is now beginning to ease. Companies have recruited more workers and supply chains are recovering, despite the war in Ukraine causing some additional disruption. In the US, inflation reached a peak of 9.1% in the summer and has been trending downward ever since. It currently stands at 7.1%*. Europe and the UK have a bigger fight, due to substantially higher energy prices. However, the oil price has fallen significantly recently, which should help to ease inflation in the year ahead.

What about wage inflation? We are seeing an increasing number of strikes and demands for higher wages, will this lead to higher inflation for longer?

This is not the 1980s. These strikes are disruptive and high profile because many public service workers are in unions. However, the reality is that union membership has been on the decline since the early 80s. Most people in the UK work in the services sector, which is less unionised, and they tend to receive annual pay rises at moderate levels.

Oil has fallen sharply from the high reached in February 2022

*Data source: Trading Economics. Chart source: Bloomberg.

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So, we do not anticipate the strikes and any resulting pay increases having a significant overall impact on inflation.

However, the strikes could have a short-term impact on markets. As the effects of higher inflation continue to bite in 2023, we could see an escalation of industrial action and this disruption could undermine confidence in UK companies, putting downward pressure on share prices.

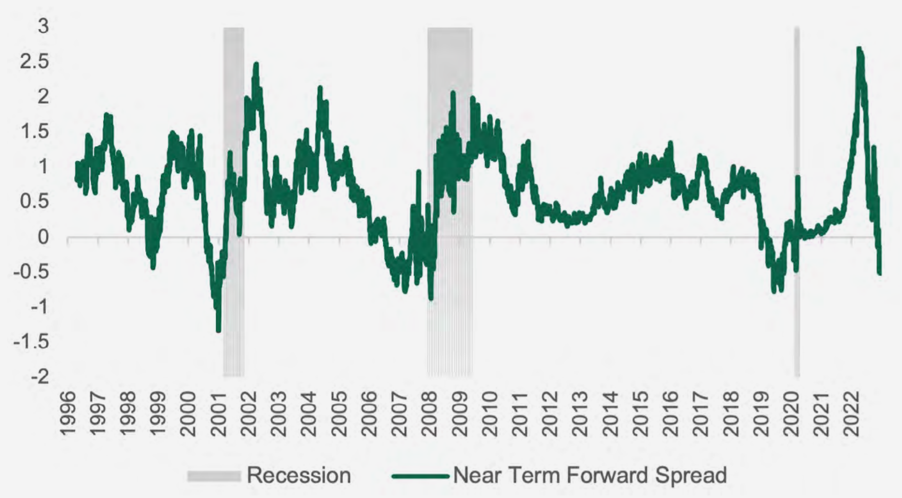
Returning to inflation, we see another reason why wage demands are unlikely to drive it up. Higher costs resulting from inflation are causing companies to reassess their cost structures, which means recruitment freezes or layoffs, reducing the likely potential for a wage inflation spiral. This has already begun, with many high-profile technology companies announcing recruitment freezes.

2. Recession

Will there be a recession in 2023 and how bad will it be?

The reality is many recessions are caused by governments and central bankers, albeit not deliberately. Central banks raise interest rates to cool inflation, ultimately taking money out of the system as people decide to save instead of spending their money. The higher the interest rate, the greater the incentive to save. This leads to lower growth because there is less spending in shops and sectors such as hospitality and leisure. As a result, when central banks raise interest rates, it can cause a recession. However, it is worth highlighting that growth has been resilient in many regions, despite higher interest rates. Some of this can be attributed to the fact that there is still a lot of pent-up demand post-Covid, which leads many investors to believe that any recession will be mild. That said, the probability of a recession in 2023 is high, and most investors expect one. If it happens, this will be one of the most well-flagged recessions in history.

Recession signal



Source: Bloomberg.

The chart above shows the near-term forward spread on US Treasuries, which is viewed as a signal of looming recession. The chart shows the expected three-month Treasury yield 18 months in the future, minus the current three-month Treasury rate. In other words, it is the expectation of Fed rate changes over the next year and a half. When the index turns negative, a recession is likely.

Is a recession bad for markets?

Yes and no. Recessions mean lower growth for companies, which means reduced profits and that is likely to have an impact on share prices. However, as we all know, markets are forward-looking - always trying to anticipate what lies ahead. Therefore, we believe that a mild recession is already priced into equity markets. This is why equity markets sold off in 2022. Investors were looking to price in the impact of higher interest rates on company profits. Often, equity markets tend to advance once a recession has actually arrived. This is because recessions bring interest rate cuts, which are designed to generate growth by encouraging people to spend rather than save. This increased spending should lead to higher profits for companies. When an economy is in recession, investors know cutting interest rates will be the next logical step in the business cycle. As a result, share prices often advance on recession news, because interest rate cuts are likely to lead to higher company earnings in the future.

When will interest rates fall?

The market is slowly coming around to the realisation that central banks are unlikely to cut interest rates when they have only just finished raising them. We are more likely to see a 'pause and ponder' period than a pivot. Central bankers will want to gauge the impact of interest rate rises on inflation and the economy. On average, central banks tend to make the first interest rate cut six months after the last rate hike.

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In reality, this will all depend on the state of the economy. If we have a mild recession, rates are likely to remain elevated for a longer period. However, a more pronounced recession is likely to result in a quicker step-down in interest rates, as central banks look to reignite economic activity.

3. Markets

How are the main asset classes likely to fare in 2023?

We are significantly more optimistic about the outlook for both equities and bonds in 2023. We expect slowing inflation and an end to rate hikes, and these will be welcomed by markets. Any recession will also draw a line in the sand, paving the way for markets to advance, as falling interest rates reduce business costs and increase profits.

Equities

Markets historically tend to rebound in the year after a big sell-off. We also tend to find that the areas that have lagged the most then tend to lead the way up: small caps, technology stocks and emerging markets spring to mind. We have been researching several funds in these areas to capitalise on a rebound. Many areas of the equity market offer significant value when you compare them to 2021 levels.

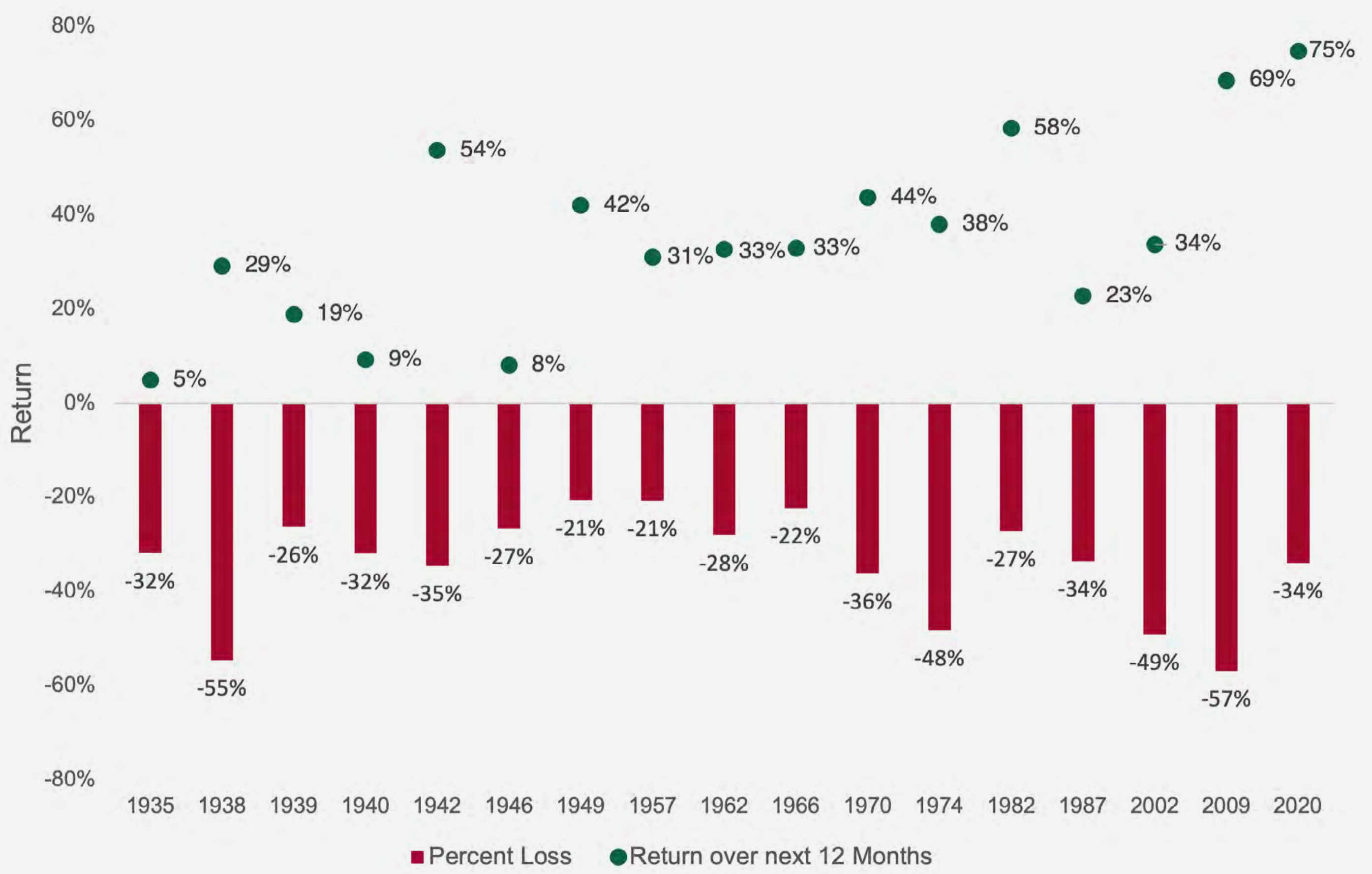
Bonds

Bond markets tend to perform well following a peak in the interest rate cycle. Generally, bond markets begin to outperform before the final rate rise, as they anticipate the next move in interest rates, which tends to be down. Additionally, given the likelihood of a recession in 2023, we expect further upside from bonds, because many investors turn to them in challenging times. Bonds offer much higher income today than they did during the years when interest rates were at historic lows. As a result, they will play a broader role in portfolios in 2023.

Property

Unlike equity and bond markets, property prices only began to fall in the latter stages of 2022 and are likely to see continued downward pressure throughout 2023. Higher mortgage costs lead to lower affordability rates, ultimately driving down housing demand and thus prices. This is likely to have an outsized impact on investor confidence. For the majority of retail investors, their home represents a large proportion of their wealth, and falling house prices will do little for their confidence in 2023.

Equity market performance in the years after bear markets



Source: Bloomberg.

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Portfolio Activity Update

We were defensively positioned throughout much of 2022, with a preference for low-risk income-orientated funds, which invest in dependable companies that are good at managing their balance sheets. These companies tend to perform well in a downturn, as their profits are less dependent on the economic cycle.

We expect to see more opportunities to add risk in 2023. One sector where we see particular potential is emerging markets. Emerging markets generally perform less well in a downturn, as many companies in these regions take out loans in dollars. The US dollar has a habit of strengthening in periods of uncertainty, meaning that these companies must fork out higher amounts to service loans. As economic conditions improve, the dollar tends to weaken, which has the opposite effect, and emerging markets often benefit from this.

We also see a specific opportunity in China. The recent performance of the Chinese economy and stock market have been lacklustre. This is for several reasons, including the crisis in the Chinese property market and extremely tight Covid restrictions. However, Beijing has introduced a number of initiatives designed to put the property market on a firmer footing and Covid restrictions are being eased.

We believe these measures will help to provide a more positive backdrop for China in 2023. We have been underweight China for much of 2022, but we have recently added the Fidelity Asia Pacific Opportunities Fund, which will provide more exposure to China for our portfolios and the ability to participate in any recovery in this market.

We expect 2023 to be a year in which many asset classes bounce back from their 2022 lows. However, the opportunities will vary across different regions and asset classes. As a result, investors will benefit from holding multi-asset portfolios that can capture these opportunities while also providing diversified exposure to help buffer the impact of less favourable market moves. As the focus shifts from inflation to recession, it is important not to allow a challenging economic backdrop to cloud your judgment. The investment opportunities thrown up by the events of 2022 do not happen often and are not to be missed.

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Registered office: IFSL International Limited, Mill House, Millbrook, Naas, Co. Kildare, Ireland.

IFSL International Limited, Mill House, Millbrook, Naas, Co. Kildare, Ireland

Broker Support: +44 (0)1204 589 336

Email: enquiries@marlboroughgroup.com

Website: www.ireland.marlboroughfunds.com

Administrator: HSBC Securities Services (Ireland) DAC, 1 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland

Marlborough Group