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Monthly
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GLOVISTA
INVESTMENTS

Glovista Global Perspectives

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2022 Review and 2023 Outlook: 2022 Annus Horribilis, Defined by Inflation/War/China Lockdown, to be Followed Post-Q1 by Market Recovery led by Disinflation/Weak US$ and Lower Real Rates

As is customary in December, this month we focus on a review of 2022's principal market developments along with an assessment of potential market dynamics to condition next year's investment outlook.

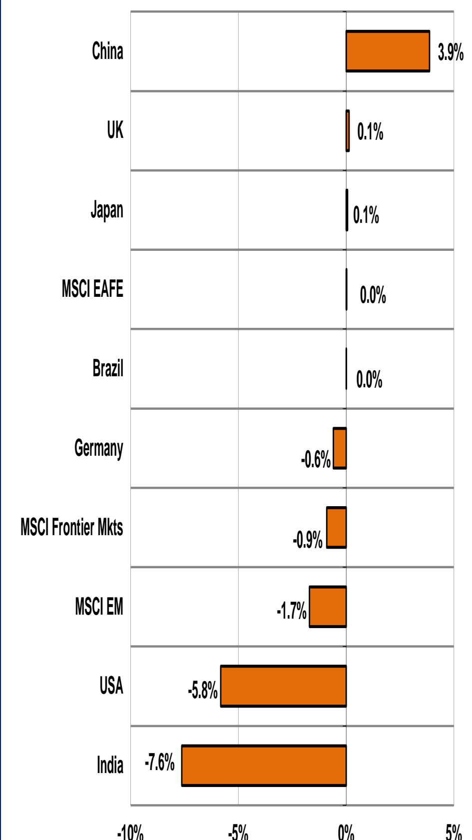
2022 Review: Real Interest Rate Spike, Europe War and China Lockdown Fuel Outsized US$ Rally and Largest Combined Stock-Bond Sell-off in Decades

With little doubt, 2022 will enter the pages of financial history as one for the record books. The destruction of financial wealth in 2022 has been nothing short of monumental as both fixed income, equities and other risk asset classes – particularly crypto and small cap growth – have posted double-digit declines simultaneously, a historical rarity that makes 2022 one of the worst years in financial history for the traditional 60/40 equities-fixed income balanced model followed by most investors. For example, *Figure 1* illustrates the 2022 year-to-date total return performance decline for the 60-40 (global equities-global bond aggregate index) balanced portfolio against returns for the prior thirty years.

In our assessment, the principal factors accounting for such adverse 2022 risk market development cut across the macro policy, geopolitical and epidemiological domains, including the following:

- ***Sharpest monetary policy tightening in decades:*** US Federal Reserve's concerns over inflation led to the sharpest policy rate tightening in decades, accumulating to a total of 450 basis points hike for the year in the Federal Funds rate. Moreover, the year saw the end of quantitative easing and the implementation of outsized quantitative tightening of monetary conditions that equates to around 200 basis points of additional hike in the Federal Funds rate so that the

Country-wise Monthly Performance in USD terms (Dec 2022)*



Source: MSCI & Bloomberg

***As of December 23rd, 2022**

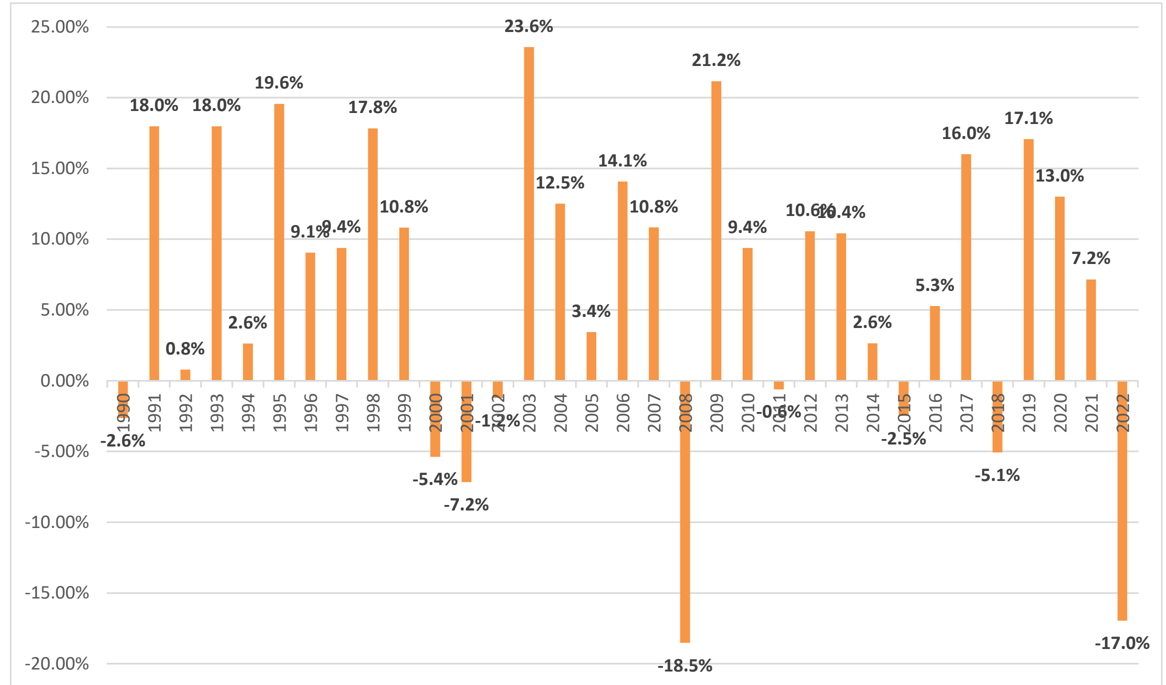
S&P500 Monthly Sector Performance –Dec MTD 2022*

Sectors	% Change	FY1 PE Ratio
Energy	-3.74%	8.3
Materials	-4.68%	14.1
Industrials	-2.94%	20.7
Cons Disc	-11.07%	24.0
Cons Stap	-2.28%	21.9
Technology	-8.28%	21.2
Healthcare	-1.86%	16.8
Financials	-6.07%	14.3
Utilities	-0.12%	20.2
Telecom	-7.77%	14.2
Real Estate	-4.89%	29.8
S&P500	-5.77%	17.5

as of Dec 23rd 2022

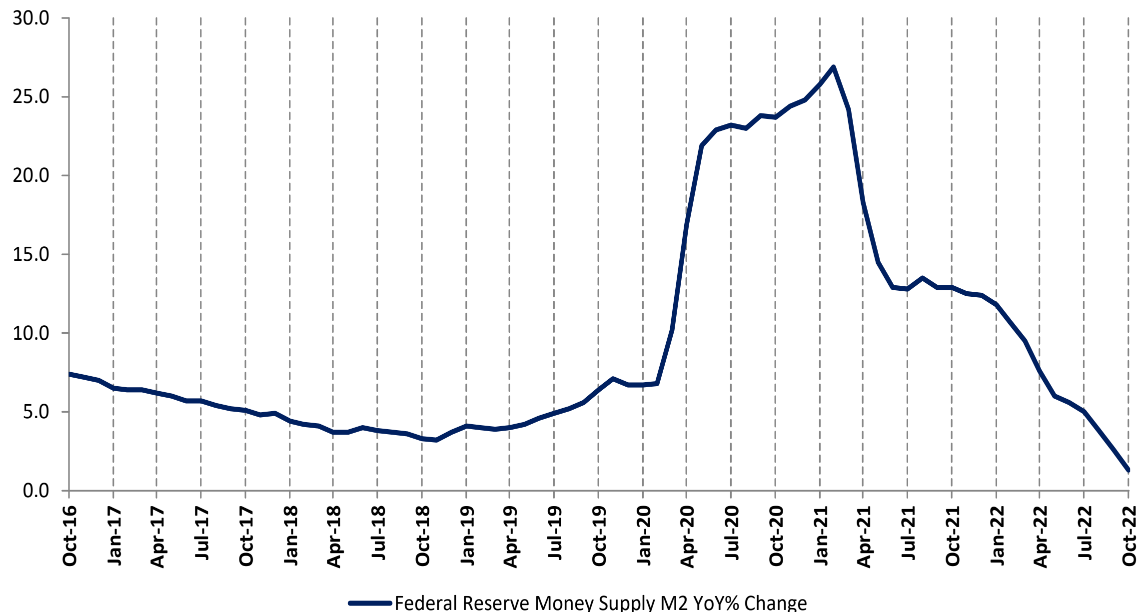
effective Federal Funds rate saw a grand total (explicit and equivalent from quantitative tightening) raise of around 650 to 700 basis points. In addition, 2022 also witnessed the initiation of policy rate hikes by the European Central Bank and Bank of England, among other large developed country central banks. *Figure 2* also highlights the massive swing in year-on-year monetary base (M2) growth.

Figure 1. 2022 Qualifies as Annus Horribilis for the 60/40 Balanced Model: Calendar Year Returns of Balanced Index of MSCI World TR Index and Bloomberg Barclays Global Aggregate Bond Index



Source: Bloomberg & Glovista Calculations

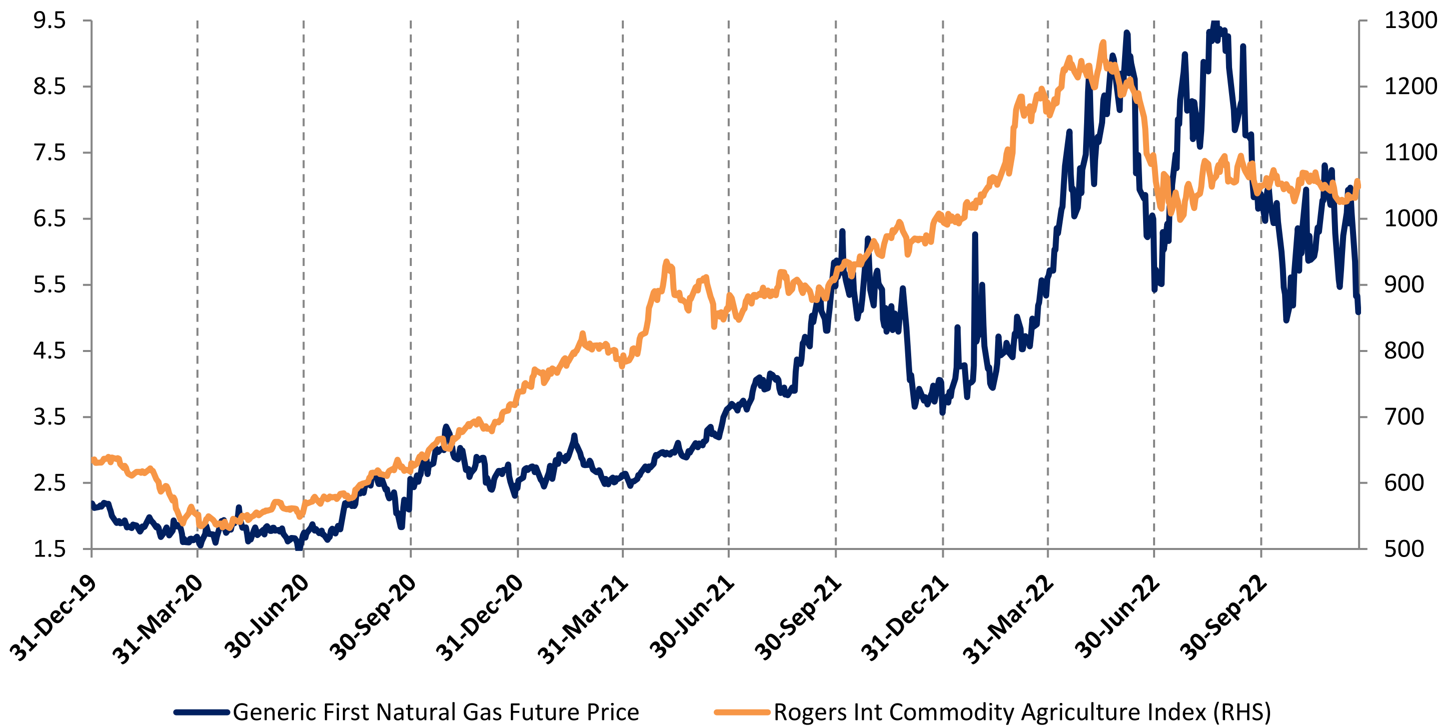
Figure 2. US M2 Year-on-Year Growth Implodes in 2022, Courtesy of Sharp Succession of FED Policy Rate Hikes and Quantitative Tightening Measures



Source: Bloomberg

- ***Onset of Largest Land Mass War in Europe since World War II:*** In February, Russia's invasion of Ukraine led to major disruptions across various markets of critical importance to the world economy, including food and energy. Such disruptions translated both into parabolic spikes in the price of selected energy and agriculture commodities along with trauma in the supply chain for such commodities, particularly to less developed regions of the world, especially Africa. *Figure 3* illustrates the magnitude of the price spikes recorded by some of those commodity groups.

Figure 3. War in Europe Leads to Outsized Price Spikes in Energy and Agriculture Commodity Markets



Source: Bloomberg

- ***Broad-based Lockdown of the World's Second Largest Economy (China)***: Early in the year, particularly around the month of March, the Xi Jinping government implemented broad-based lockdown protocols across most of China's territory as a result of an upswing in Covid virus infection rates. Such lockdown measures have remained in place throughout most of 2022, thereby materially impacting the rate of economic growth for the Chinese economy for the year and episodically impacting the global supply chains, of which China is the most consequential member. Such China lockdown-derived disruptions in the global supply chain impacted the rest of the world economy in a stagflationary manner, reinforcing the hawkish stance embraced early in the year by developed country central banks, most notably the US FED.

From a macro perspective, Table 1 offers some quantitative context to the manner in which the three above-listed global factor developments impacted Wall Street economists' consensus estimates for output growth and inflation developments for the 2022 calendar year.

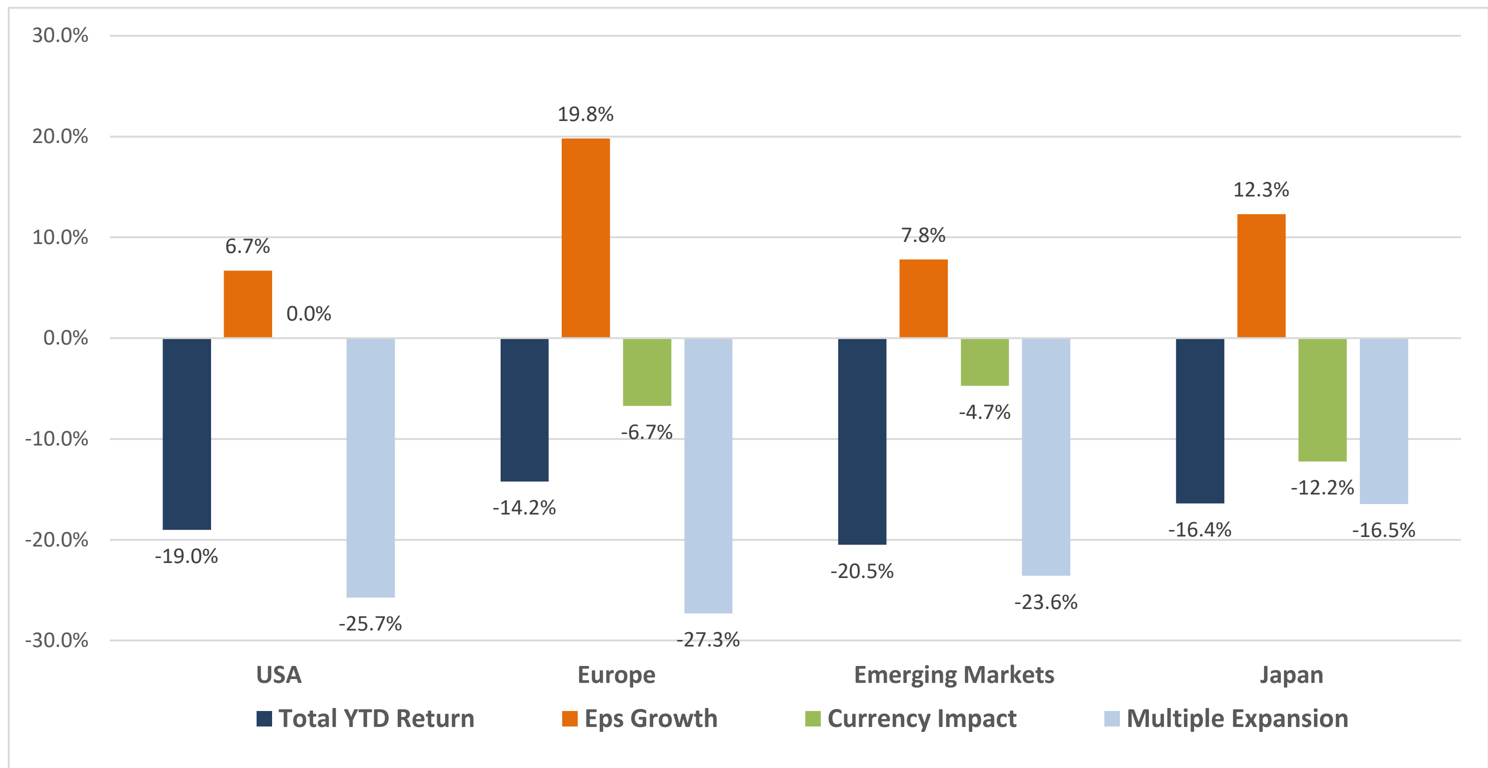
Table 1. Output Growth and Inflation Estimates Undergo Considerable Adjustments throughout the Successive Rate/War/Lockdown Shocks Impacting the 2022 Outlook

	As of Dec 31st 2021		As of June 30th 2022		As of Dec 22nd 2022	
	GDP Growth Est YoY %	CPI Est YoY %	GDP Growth Est YoY %	CPI Est YoY %	GDP Growth Est YoY %	CPI Est YoY %
Global	4.4	3.9	3.2	6.7	3.1	7.5
Developed Economies	3.9	3.5	2.7	7.3	2.6	8.6
Emerging Economies	5.0	4.1	3.6	5.8	3.1	6.4
USA	3.9	4.4	2.5	7.5	1.9	8.0
China	5.2	2.2	4.1	2.2	3.0	2.1
Euro Area	4.2	2.5	2.8	7.2	3.2	8.5
Japan	2.9	0.7	1.7	1.9	1.4	2.4
India	7.6	5.0	7.1	6.7	6.9	6.7
Brazil	0.8	5.9	1.0	9.9	3.0	9.3

Source: Bloomberg

From a market perspective, *Figure 4* offers some quantitative light to the contribution exerted on equities' total return declines in 2022 by earnings, currency and valuation multiple (related to the adverse effects stemming from this year's spike in real bond yields factor). We observe that most of this year's price declines emanated from multiple compression as opposed to downside earnings surprises.

Figure 4. 2022 Equity Index Declines: Currency, Valuation Multiple and Earnings Contributions



Source: Bloomberg, Yardeni Research and Glovista Calculations

Happily, in 2022 we embraced a host of investment themes that led to the outperformance of our portfolios across strategies, most notably bullish value versus growth style orientation as well as underweight fixed income duration and underweight low-quality factors.

We expect the constellation of factor dynamics that drove absolute and relative performance in 2022 to undergo material changes in 2023, with considerable dispersion across regional blocs.

2023 Outlook: Non-US Risk Markets, led by EM, Likely to Outperform Strongly in 2023 as G3 Activity Outlook and Policy Uncertainty Fade in Q1 and US Dollar Cycle Top is Confirmed

As we look ahead to 2023, the Glovista investment team expects the global economy to slow down yet avert more than a modest recession as already ingrained goods sector disinflationary trends assert themselves, lending support to household sector confidence and expenditure levels. However, the deterioration of corporate profit margins and diminished savings pools (both particularly in the US) are likely to result in downside capex surprises and the shedding of labor. Hawkish central bank stances, particularly in the US and the UK where output gap levels are tighter than elsewhere (Europe and Japan), suggest downside economic risks (versus consensus estimates) are larger in the US and the UK. As a result, we believe the nascent Q4 top in the US Dollar cycle is likely to prove a durable top, extending throughout the next 12 months and possibly longer.

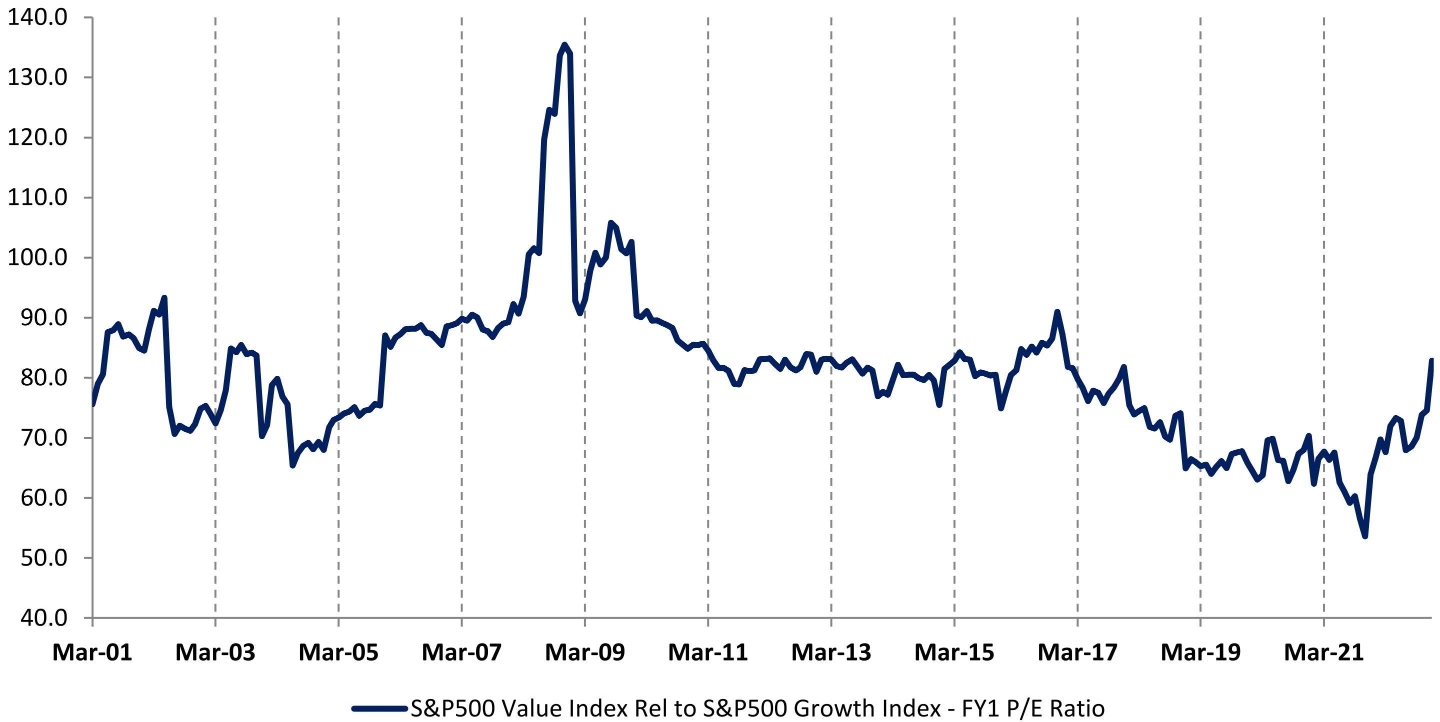
In the international sphere, we believe the potential for downside earnings surprises in 2023 is far smaller than in the US not only because of our assessment of the skew of downside economic growth risks between the US and the rest of the world but also because the lack of tight output gaps in Europe, Japan and most of the emerging markets world translate into far smaller downside risks to profit margin erosion. Finally, the adverse household expenditure growth dynamic in the US tied to the erosion of household savings throughout 2022 is not present in the rest of the world as the monumental magnitude of pandemic-era government transfers to the household sector was predominantly a US affair.

As we enter 2023, we expect to sustain our longstanding defensive stance vis-à-vis risk markets, entailing both underweight equities allocation and overweight value/underweight growth, overweight high quality/underweight low quality factor exposures. Such themes carry over at the asset class (equities, credit) as well as the geographic level (both within developed and emerging markets). Such a defensive stance is predicated on our assessment that the first quarter of 2023 is likely to prove the period of "maximum ambiguity" with regards to the potential for a recession and downside earnings surprises, let alone the timing by when the US FED and the European Central Bank signal the end of their longstanding tightening stance.

From a valuation perspective, we are encouraged to sustain our overweight value, underweight growth stock style exposure early in 2023 in the US. For example, *Figure 5* illustrates the relative valuation discount between US large cap value and US large cap growth stocks. Within emerging markets we are more constructive growth stocks, primarily Chinese ones. A similar relative valuation conclusion obtains when parsing over the US and emerging markets pair, as illustrated in *Figure 6*. Specifically, at 2022 year-end price levels, emerging market stocks hover at close to 44.5% relative P/E valuation discount versus US equity peers, as represented by the S&P500 index.

Within the fixed income domain, we continue to favor high quality, intermediate duration exposures on account both of our defensive macro baseline case for the first half of 2023 as well as valuations that insufficiently reflect such potential for downside risks, especially in the US. In the commodities space, we favor modest exposure to gold given our expectation of limited additional upside to real rates throughout the developed world.

Figure 5. US Value Stocks Continue to Hover at Attractive Valuations versus Growth Peers at End 2022, despite Solid 2022 Relative Performance for the Group



Source: Bloomberg

Figure 6. Emerging Market Stocks Trade at 44.5% P/E Multiple Discount versus SP500

Source: Bloomberg

Within the emerging markets space, 2022 return performance for the asset class proved to be a 'tale of two cities'. Specifically, the EM asset class outperformed US equities – with the exclusion of the two geopolitically and pandemic afflicted countries (Russia and China). Valuation cheapness, currency resilience (given that most EM central banks had hiked policy rates in 2021, well before the FED) and relative earnings growth accounted for the bulk of the solid relative performance.

As we look ahead to 2023, it is important to note that Russia is no longer part of the MSCI EM benchmark. As for the China market, the 2023 outlook has been vastly enhanced on the back of recently announced government decisions to gradually lift the drastic lockdown protocols that had been in place over most of the year. Such increased visibility of household expenditure growth in 2023 - given the elevated service sector pent-up demand growth - along with the support afforded by high domestic savings accumulated during the lockdown period (similar to the US experience), make the China market a likely outperformer in 2023. In addition, contrary to developed country central banks, the People's Bank of China is easing domestic liquidity conditions, a tailwind to local financial asset prices. As for geopolitical risks tied to the China-US relationship, particularly with regards to Taiwan, we are comforted by the rapprochement between the US and China that started at the G20 Bali summit earlier this quarter. In addition, we believe that unless provoked China is unlikely to initiate a Taiwan invasion over the foreseeable future. Such a view reflects a number of considerations, including:

- Our respect for the absence of invasion precedents in modern China history (distinct from Russia in Crimea and its predecessor, the Soviet Union);

- The Chinese economy's cyclically challenged stance as it navigates a juncture in which its traditional growth engine, the property market, normalizes. The latter is likely to be a longer-term phenomenon given the fast deceleration in household formation over the coming years, a legacy of the one-child policy;

- The ongoing reconfiguration of the world geopolitical order, following Russia's invasion of Ukraine, in which the US has become materially strengthened through the tightening of its alliances with North Atlantic European powers as well as India Australia, Japan and South Korea. Such alliances resulted in the weaponization of finance (including the US Dollar) as well as the imposition of material sanctions on Russia. China's leadership is assured to have internalized such dynamics in its regional geopolitical calculus, including the potential for a Taiwan invasion.

Outside China, we favor a number of Latin America and South East Asia markets as likely outperformers in 2023 while mitigating our bullishness towards Middle Eastern and India equities, primarily on valuation considerations. At a global level, we believe emerging market growth stocks are most compelling and such view finds its most appropriate expression via China equity plays.

As the year draws to a close, we thank all of our clients for your continued confidence in our team and extend our best wishes to you and your loved ones in 2023. May the New Year bring peace, joy and prosperity to all.

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