ROBERTSON STEPHENS®

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Bumpy Markets

The MSCI AC World gained 2% last week. The Chinese and European markets outperformed the U.S. market on the back of an accelerated re-opening in China, a mild winter in Europe and lower inflation prints. The Investment Office is mindful of China reopening and its potential impact on inflation. China's bumpy reopening is a key source of upside demand for certain sectors such as luxury goods. However, the reopening also provides risk to global growth as well as commodity prices in 2023, which could worsen inflationary pressures elsewhere and raise central banks' challenge to tame inflation without a recession. As a result, monetary policy in Western countries may have to stay tighter for longer.

An old saying is that when a major economy sneezes, the world economy catches cold. As China catches more COVID and it struggles to address its property sector challenges, the uneven impact on its reopening on world financial markets will be notable. Approximately 20% of the Euro STOXX 600 index revenue is exposed to China. In comparison, less than 5% of the S&P500's revenues depend upon China, although specific companies may have more revenue and/or supply chain concentration.

2023 Catalysts

The path for both nominal and real interest rates will be central to the returns for 2023. Last week, rates fell across the yield curve. The recession-watch 3month-10year spread fell a further 54bps and closed the week at -107bps, the lowest level since 2002, signaling a recession in the next several months. The 2year-10year spread fell 14bps and is now -70bps; recent levels have not been seen since the early 1980s. Rates were modestly down in other developed markets. The European Italian BTP-German Bund spread tightened 13bps to 2.02% we believe indicating lower recession concerns. Finally, the 5-year and 10-year breakeven inflation expectations fell and now sit at 2.23% and 2.21%, respectively and the 10Y real yield fell 24bps to 1.34%. As inflation peaks but central banks continue to tighten, real rates may move higher forcing equity valuations lower still. The latest inflation print will be released on January 12th. We believe inflation is heading in the right direction and has passed its peak level. However, its decline is likely to be bumpy where certain consumer price inflation (CPI) service components may be stickier than goods components, and some calculations such as housing operate with a lag.

With the economy struggling with elevated inflation and companies facing difficult earnings comparisons with last year, we believe the fourth-quarter earnings season will be challenging for the overall market and individual companies. As a result, forward guidance regarding the ability of companies to pass on higher prices to protect profit margins will remain a critical focus. Nine S&P 500 companies are scheduled to report earnings this week, but the initial focus will be on the banks. In particular, the Investment Office will be interested in their views regarding the operating environment, the strength of core lending and the trend in credit defaults.

We also believe the transition from top-down macro to bottom-up fundamentals will be bumpy as analysts tend to think that the unfavorable growth-inflation mix may lead to a corporate earnings recession. Most bottom-up analysts, however, have only modestly adjusted their 2023 forecast expectations. For the S&P 500 Index, the consensus still represents approximately 5% growth over 2022 earnings. For comparison, many Wall Street economists are now forecasting a U.S. recession in 2023, and the latest forecast from the International Monetary Fund puts global economic growth in 2023 at 2.7%.

The situation is similar in credit. Historically, recessions have tended to push the U.S. high yield default rate up to 10% or more. Again, bottom-up credit analysts say they are struggling to stress current corporate balance sheets to a default rate higher than the long-term average of 3% in 2023.

Our current resolutions over 2023 include:

- Constructing portfolios for the end of free money.
- Returning to basics with high-quality municipal and investment-grade credit.
- Increasing international exposures.
- Searching for value in growth sectors and repositioning equities with more exposure to mid and small-cap companies.

These resolutions are against a backdrop where we expect a pause in U.S. rate hikes as the effects of the U.S. central bank policy take hold and believe Chair Powell's commitment to keeping rates elevated.

Disclosures
Investment Commentary Sources: Bloomberg and Morningstar
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