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Strategy & Outlook

MARKET UPDATE

JANUARY 2023

Global equities were almost unchanged in euro terms in the fourth quarter (+0.3%), ending the year on a poor note with a -7.5% drop in December. The rally in the euro over Q4 (+9.2% against the US dollar) disguised much stronger returns: the fourth quarter saw US equities 6.6% higher in local currency terms, Chinese equities 12.7% higher, whilst European equities were 10.0% higher. US bond yields remained volatile, ongoing hawkish rhetoric from the Federal Reserve offsetting better inflation data, whilst European bond yields moved sharply higher as the ECB turned significantly more hawkish.

Over the course of the quarter, the general theme was one of growing evidence that inflation has peaked, central banks are slowing their pace of rapid tightening whilst arguing that rates should end up being higher for longer to control inflation, and growing fear of recession.

Inflation, and fear that it would become entrenched, has been the root cause of aggressive central bank action this year, pushing financial asset prices significantly lower over the year (global equities fell by -13%, European bonds by 24%, US bonds by 20%). But the evidence is clear: inflation is falling, fast. Used car prices in the US, according to the Manheim Index (which leads CPI car prices by a couple of months) are now down 14% year over year. One of the largest housebuilders in the US said simply: “building costs are coming down”. The Adobe Digital Price Index showed that online prices fell 1.9% in November, the largest drop in 2.5 years. The structural pre-COVID-19 deflationary forces in a digital world have re-established themselves. This survey is the most comprehensive survey on digital pricing in the world and was created by Austan Goolsbee, the new president of the Chicago Fed, and a voting member of next year’s FOMC. Gasoline prices in the US have fallen so much from their peak levels they are flat on the year 36% off their highs. The impact this has on inflation, consumer spending and corporate margins into 2023 cannot be understated.

US yields and yield curves, the dollar, rate cut expectations for the second half of 2023 and short-term inflation expectations all reflect this reality, even if the Fed’s outlook hasn’t yet. While the Fed’s rate hike cycle is almost at an end, the ECB has made it clear that it is only at the beginning of its rate normalisation process. However, their moves are likely to be more gradual from here as they have already stepped down their pace. As we move through 2023, the BoJ is likely to continue to gradually tighten policy. But the most aggressive global hiking cycle in history is close to an end.

Recession fears will now take over as reasons not to invest. Forecasts are overwhelmingly in favour of economic recession and large declines in earnings and, for the first time in decades, Wall Street strategists are forecasting a down year for stocks next year. We would see this as a contrarian buy signal.

Although certain areas of the global economy are slowing, (US Housing, UK Economy) and others will struggle to maintain lofty levels such as the US labour market, the latest evidence is of a global economy constantly surprising to the upside, notably in areas over which people had valid concerns. PayPal highlighted how the US consumer is maintaining spending into year end, this being corroborated by Mastercard’s spending data over the key BFCM period.

Continued on next page

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Strategy & Outlook *Continued*

Bank of America highlighted how they see consumer spending consistent with 2% GDP growth. JP Morgan's Jamie Dimon downplayed his own infamous "hurricane" speech of the summer. Nike told us that "our current headwinds such as foreign exchange and inventory challenges are transitory, but our tailwinds are structural". They are clearing inventory faster than expected even as new product arrives "earlier with faster transit times". China is reopening far quicker than even the most bullish estimates, and in a pro-growth manner. US capex spending is increasing as we enter 2023. Ashtead (industrial and construction equipment rental) highlighted the three legislative acts (Infrastructure Investment and Jobs, Chips and Science, and Inflation Reduction) mean there is "a trifecta of government investment equalling nearly $2 trillion in investment that will indeed create thousands and thousands of projects"

These projects encompass old infrastructure, new energy and advanced technology driving the economy for the next decade.

Positioning

All of the above leaves us with a very positive outlook for asset markets. Recession is fully expected but not guaranteed next year. Inflation will continue to recede. The Fed is near the end of its rate hike cycle. China is reopening fast. The consumer, very resilient up to now, does face significant headwinds, but investment spending as outlined above should drive economic activity.

The funds remain at the top end of their asset allocation and had a strong quarter in absolute and relative terms. Active positions in FX (dollar hedging), bonds (overweight peripheral Europe and long-dated US treasuries) and equities (long-standing overweight positions in US semi-conductors and European industrials, as well as the tactical decision to materially increase FANG and EM exposure earlier in November on a record collapse in their share prices) have all contributed strongly to performance. Stronger than expected global growth in 2023, faster than expected China reopening, a weaker US dollar, falling inflation and a tailwind from an end to ever more restrictive monetary policy all serve to provide an extremely positive backdrop for equities as we move into 2023.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment may go down as well as up.

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