KEYSTONE

A Year of Recovery

KEYSTONE CAPITAL
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After the last three years of making impossibly difficult forecasts in the face of entirely unpredictable set of events that subsequently followed, we could be forgiven for being tempted to retire this annual ritual. Instead, we thought we would keep it simple this year, taking stock of where we find ourselves after a tumultuous twelve months and a brief commentary on how we see the base case scenario for financial markets evolving in the year ahead, of course this time with more caveats than ever before!

Last year turned out to be one of the worst years for financial assets that we can remember with nearly all major asset classes registering significant losses. Global equities recorded losses of c.18% over the course of the year whilst government bonds in general recorded losses of c.15%. Such was their correlation that asset managers found nowhere to hide and if there were any good news stories, it was really about how they had managed to minimise those losses in client portfolios and contain volatility along the way.

So, are we to expect anything different in 2023? In short, we think that there will be continued volatility in markets the first half of the year. The earliest any potential recovery in markets is likely to be in the second half of the year, around the summer/autumn time. Markets are always forward looking, often by several months, and so it is almost certain that a recovery in financial markets will precede a recovery in the health of the underlying global economy, which we think may not come until the end of this year or perhaps even into 2024. For those invested, it will be a matter of keeping their cool and riding out the storm, whilst those fortunate to have large cash positions may start to find some opportunities in the coming months. For

any history and statistics buffs out there, here is an interesting historical statistic: the median 1-year and 2-year returns of the S&P 500 from a recession trough going back over ninety years is 37% and 58% respectively.

INFLATION & CENTRAL BANK POLICY

The key question on everyone's mind right now is when will inflation peak and therefore when will the monetary policy tightening being pursued by Central Banks come to an end. Whilst there are already some signs of headline inflation starting to ease in the US, core inflation continues to remain stubborn and we anticipate that Central Banks, specifically the Fed, will continue on their current path of tightening until there are very clear signs of inflation coming under control, even if this means tipping the US economy into a mild recession. It is very likely that we will see corporate earnings come under pressure in the first half of the year with unemployment numbers also beginning to rise. This adverse news flow in turn could translate into further volatility in financial markets. We anticipate the US economy will enter a recession early in the year, albeit likely a short and shallow one, but the same cannot be said for Europe and the UK with its proximity to the war as well as reliance on energy from outside.

Another significant contributing factor to persistent inflation and weak global growth has been China's adherence to a strict Zero COVID policy. On the one hand, relaxation of such stringent measures internally over the festive period should help ease global supply chain bottle necks in time and therefore add to the easing of inflationary pressures, however, COVID cases and deaths related to it continues to rise at an alarming rate in China and so it might be a while yet before we start to feel any benefits from this change in stance, including a recovery in the Chinese GDP. There also appears to be no end in sight for the war in Europe and events there will continue to dominate headlines from time to time and have an adverse impact on the global economic recovery until some sort of negotiated peace agreement is reached.

TAIL RISKS

Whilst we would hope that new conflicts are unlikely to emerge in such a difficult economic backdrop, for many autocratic rulers they can nevertheless be a distraction from the unpopular

domestic polices and economic failures and there are several flash points across the globe that have the potential to result in another full-blown conflict, not least in Southeast Asia. When forming a long-term investment strategy, we simply need to be mindful that there is a considerable degree of instability in many parts of the world that could have a direct consequence on economic prosperity in the short to medium term.

LONG TERM TRENDS

In previous annual forecasts, we identified some of the long-term trends that we think are irreversible and we continue to stand by these. The technology sector continues to see new innovations with each passing year and new technologies will help with productivity gains whilst driving down costs (i.e., primarily suppressing wage inflation). We anticipate continued growth in this sector specifically with advances in 5G, rise of Artificial Intelligence, and the continued high demand for semi-conductors. Another sector where there has been no let-up in demand is healthcare. With an aging population in many developed nations, investment in this sector is set to accelerate even further with a focus on personalised medication, preventative care, wearable monitoring devices and reliance on robotics for the provision of basic care.

Finally, we anticipate a renewed enthusiasm and accelerated investment in new renewable energy sources in the coming years. Originally driven by the commitment to a transition to a net-zero position, the war in Europe has exposed the weaknesses of not being energy independent and has focused minds sharply on trying to remedy this situation. Expect there to be rapid developments in this area but additionally opportunities in other green technologies such as carbon capture, carbon offset, battery storage and recycling.

CONCLUSION

The consensus among many economists is that Global GDP will only see a meagre growth of between 1-2 % in 2023 followed by a mild improvement through 2024. The all-important inflation figure is expected widely to settle down to somewhere between 4-5% by the end of the year. Policy tightening in response to inflation needs to be watched carefully though. Often the

effects of interest rate rises are not clearly felt until 12-18 months after the event and the Central Banks have the unenviable task of determining when to pivot on their policy position and call an end to rate rises. One thing that markets absolutely detest is uncertainty and until there is clarity on the direction of interest rates, sentiment is likely to remain cautious or even negative.

Given this backdrop, our asset managers have positioned client portfolios defensively. Portfolios are largely underweight equities given the uncertainties in the near term. As such equity exposure is skewed towards large cap, high quality companies that have a strong balance sheet and a market leading proposition with the ability to pass rising costs on to the end consumer. Although currently most portfolios have a neutral positioning on fixed income securities, our asset managers are already looking for emerging opportunities in both corporate and government bonds. Most managers are also positive on alternatives and particularly view attractive opportunities in real assets and commodities. Additionally, we have agreed that cash positions within client portfolios can remain elevated for the time being to take advantage of any tactical opportunities that may arise in the coming months. This may sound like a recording on repeat, but it really is worth remembering that when it comes to devising a successful long term investment strategy, the two most important factors above all are diversification and time in the market.

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Annualised
U.S. equities 32.6%	REITs 22.8%	Japan equities 9.9%	High yield 14.3%	China equities 54.3%	Cash 1.9%	U.S. equities 31.6%	China equities 29.7%	Commodities 38.5%	Commodities 22%	U.S. equities 12.5%
Japan equities 27.3%	U.S. equities 13.4%	U.S. equities 1.3%	Infrastructure 12.4%	EM equities 37.8%	DM gov. debt -0.4%	Infrastructure 27%	U.S. equities 21.4%	REITs 32.5%	Cash 1.3%	Infrastructure 6.5%
Europe equities 26%	Infrastructure 13%	Emerging debt 1.2%	U.S. equities 11.6%	Europe equities 26.2%	IG credit -3.5%	Europe equities 24.6%	EM equities 18.7%	U.S. equities 27%	Infrastructure -0.2%	Japan equities 5.9%
Infrastructure 15%	China equities 8.3%	REITs 0.6%	EM equities 11.6%	Japan equities 24.4%	High yield -4.1%	REITs 24.5%	Japan equities 14.9%	Europe equities 17%	High yield -12.7%	Europe equities 5.2%
High yield 7.3%	Emerging debt 5.5%	Cash 0.1%	Emerging debt 10.2%	U.S. equities 21.9%	U.S. equities -4.5%	China equities 23.7%	IG credit 10.1%	Infrastructure 11.9%	Europe equities -14.5%	REITs 5%
China equities 4%	IG credit 2.5%	Europe equities -2.3%	Commodities 9.7%	Infrastructure 20.1%	Emerging debt -4.6%	Japan equities 20.1%	DM gov. debt 9.5%	Japan equities 2%	IG credit -16.1%	High yield 3%
REITs 2.8%	Cash 0.1%	High yield -2.7%	REITs 6.9%	High yield 10.4%	REITs -4.8%	EM equities 18.9%	High yield 7%	High yield 1%	Japan equities -16.3%	China equities 2.6%
IG credit 1.8%	High yield 0%	DM gov. debt -3.3%	IG credit 6%	Emerging debt 9.3%	Infrastructure -9.5%	Emerging debt 14.4%	Europe equities 5.9%	Cash 0%	Emerging debt -16.5%	EM equities 1.8%
Cash 0.1%	DM gov. debt -0.8%	IG credit -3.8%	Japan equities 2.7%	IG credit 9.3%	Commodities -10.7%	High yield 12.6%	Emerging debt 5.9%	Emerging debt -1.5%	DM gov. debt -17.5%	Emerging debt 1.3%
EM equities -2.3%	EM equities -1.8%	China equities -7.6%	DM gov. debt 1.7%	REITs 8.6%	Japan equities -12.6%	IG credit 11.8%	Cash 0.7%	IG credit -2.1%	U.S. equities -19.5%	IG credit 1.3%
DM gov. debt -4.3%	Japan equities -3.7%	Infrastructure -11.5%	China equities 1.1%	DM gov. debt 7.3%	EM equities -14.2%	Commodities 11.8%	Infrastructure -5.8%	EM equities -2.2%	EM equities -19.7%	Cash 0.8%
Commodities -5%	Europe equities -5.7%	EM equities -14.6%	Cash 0.4%	Commodities 1.7%	Europe equities -14.3%	DM gov. debt 5.6%	REITs -8.1%	DM gov. debt -6.6%	China equities -21.8%	Commodities 0.2%
Emerging debt -6.6%	Commodities -17.9%	Commodities -23.4%	Europe equities 0.2%	Cash 0.8%	China equities -18.7%	Cash 2.3%	Commodities -9.3%	China equities -21.6%	REITs -23.6%	DM gov. debt -1.2%

Key: Equities Bonds Private markets, commodities

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, **1 January 2023.**

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