ALVARIUM TIEDEMANN | AlTi

January 2023

Quarterly Market Update and Outlook

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Executive summary

Looking back: 2022 was an anomaly

- Both stocks and bonds declined in 2022. As inflation increased, the Fed and other global central banks embarked on monetary tightening by raising interest rates aggressively.
- The traditional 60/40 stock/bond portfolio was down 16%, its worst performance since 2008's global financial crisis and, prior to that, 1932[i].

2023 should be a better year for risk assets

- Negative returns in both US stocks and bonds over any 12-month window have occurred only 2% of the time since 1926. Back-to-back negative returns in equity markets have happened less than 10% of the time in almost 100-years[ii].
- Net bearishness is close to record highs and investor positioning is cautious. When markets decline and sentiment remains low, future returns are often unusually strong[iii].
- Since 1942 there has never been a US stock market fall in the year after US midterms and the average gain has been more than 15%[iv].

Near-term caution

- Inflation in the US has peaked and is heading lower. However, the Fed has sent a clear message that there is still hard work ahead to reach its objective.
- We expect the Fed tightening cycle to continue, with another three rate hikes. This would result in a Fed Funds terminal rate of 5.25%, a level that could be sustained for some time.
- Monetary tightening impacts economic and earnings data with a lag. A slowdown is likely coming, though it's too early to tell its magnitude and resultant impact on the economy and earnings.

Medium-term constructive

- We do not rule out a soft landing, meaning that the Fed achieves its objective of slowing inflation without creating a recession in the US economy. This would be an upside surprise for 2023.
- Inflation should improve enough to allow the Fed to end its rate tightening cycle and potentially begin to ease. This could be the trigger for a more sustainable rally in risk assets.
- Peaks in US inflation and the end of the Fed's raising of rates have typically coincided with equity market bottoms.

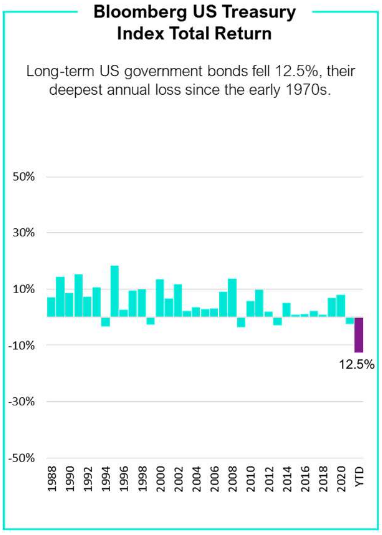
Asset allocation positioning

- We believe we are entering a different investing environment than the one characterized by the past decade, which was dominated by large cap growth and US equities.
- We see more fertile ground for diversification across our strategy categories of stability, diversified and growth, including an increased allocation to alternatives, where appropriate.

Insight detail

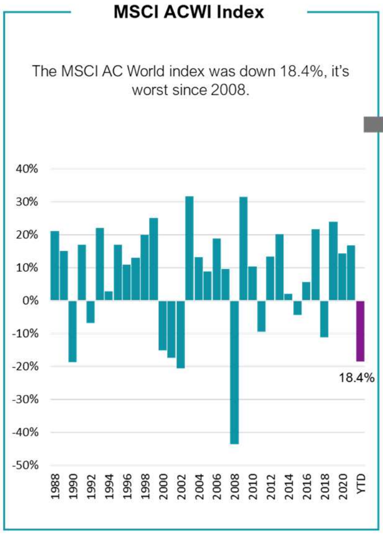
2022 was a kind of annus horribilis, with few places to hide:

- In 2022, global stocks and bonds lost more than $30 trillion in value, which was one of the worst combined equity and bond market performances in history.
- The year saw a series of record losses. The MSCI World Index had its worst performance since the global financial crisis, while the S&P 500 finished higher in only 43% of its sessions, which was the worst showing since the Second World War. US government bonds had their biggest annual loss in more than 40 years.



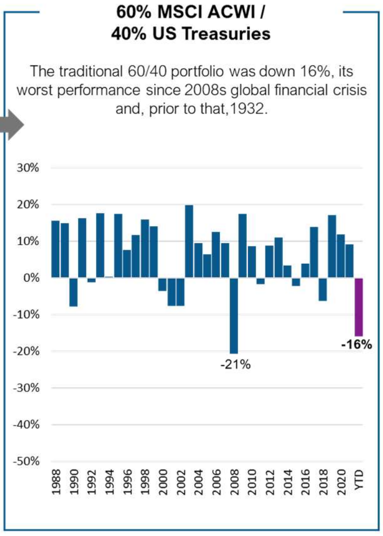
Bloomberg US Treasury Index Total Return

Long-term US government bonds fell 12.5%, their deepest annual loss since the early 1970s.



MSCI ACWI Index

The MSCI AC World index was down 18.4%, it's worst since 2008.



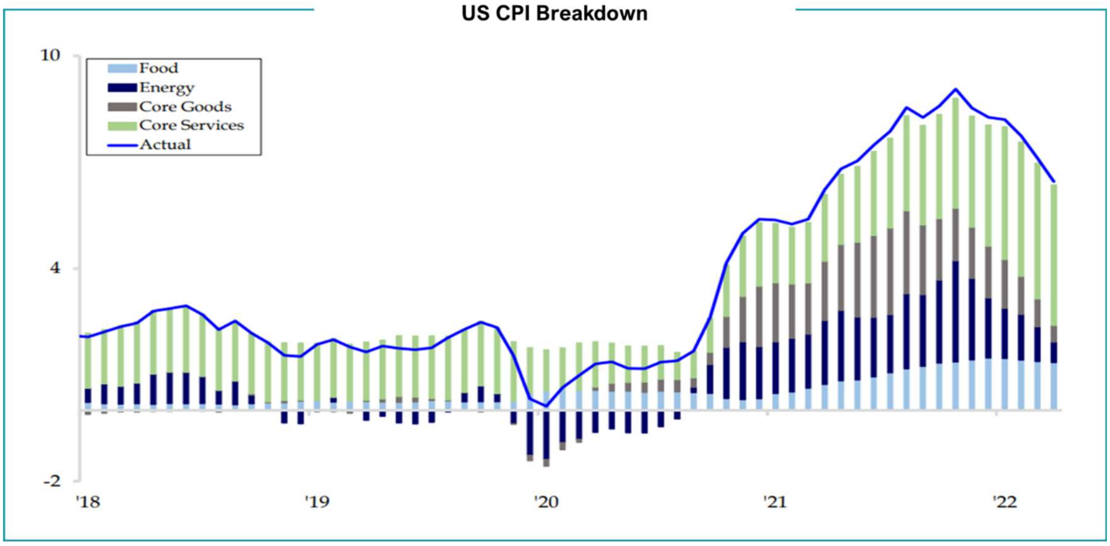
60% MSCI ACWI / 40% US Treasuries

The traditional 60/40 portfolio was down 16%, its worst performance since 2008s global financial crisis and, prior to that,1932.

Source: Bloomberg LP, 31st December t, 2022). There is no guarantee that any estimate or forecasts will be realized.

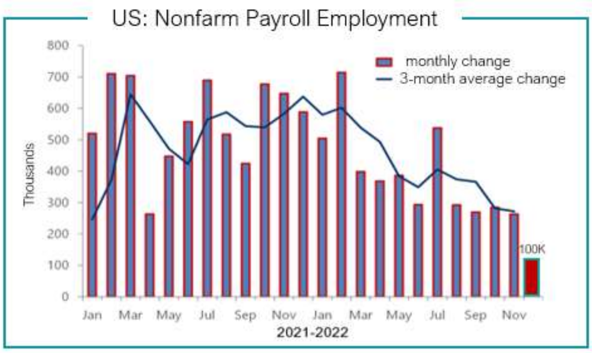
Near-term caution

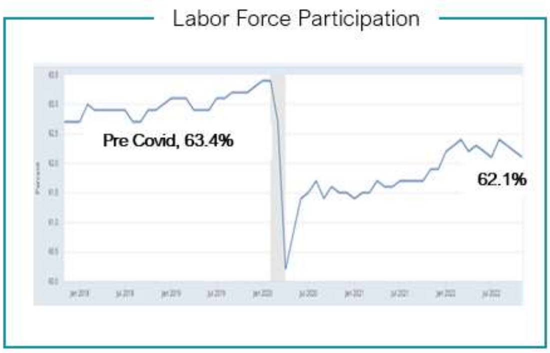
- As inflation and the corresponding tightening in monetary policy were the cause of risk assets declining, easing inflation should be the trigger for a more favorable outlook for 2023.
- As can be seen in the chart on the next page, inflation in the US has peaked. At the latest reading, December CPI came in at 6.5% versus a peak level of 9.1% seen in the summer of 2022. December CPI marked the sixth consecutive month of lower annual price increases.
- The most significant declines have occurred in energy and goods prices. Disinflation in the price of goods is expected to continue, reflecting healing supply chains and reduced demand as consumers shift their purchases from goods to services.



Source: Strategas "Charts of the week" 14 January 2023

- Service side inflation remains sticky to the upside. The largest component of this is Owners' Equivalent Rent, a measure of the tightness of the housing market. With home price appreciation slowing, we expect housing inflation to fall though it is likely to be several more months before we see true relief. Forward looking indices such as Zillow Rent Indices have already moved lower and tend to lead shelter CPI by a three-to-six-month lag.
- The Fed's other serious concern is the 3.5 million workers who left the labor force since Covid and have not returned, lowering the labor force participation rate. As the economy reopened post-Covid, demand for workers has exceeded supply, particularly in the service economy.
- The job market in the US is too hot, with monthly job gains of more than 200,000 per month. The Fed would like to see job gains of around 100,000 per month, consistent with population growth.

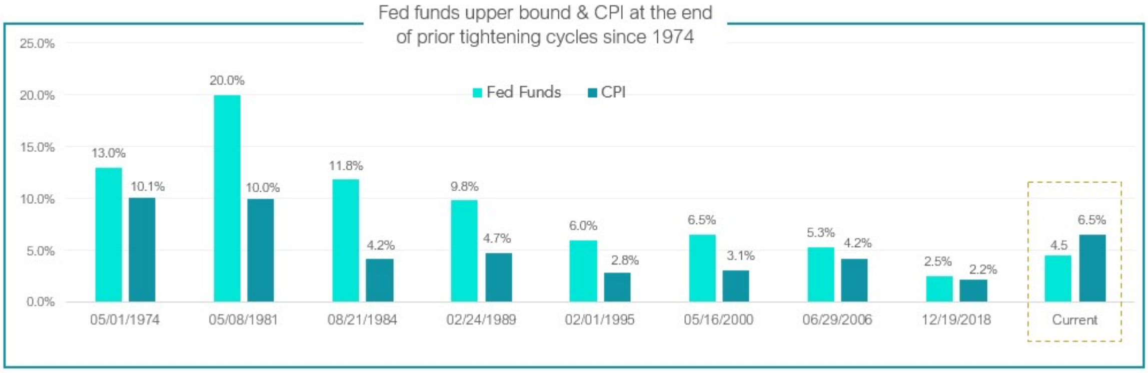




Source: Oxford Economics / Haver Analytics, December 2022. Labor Force Participation is Bureau of Labor Statistics

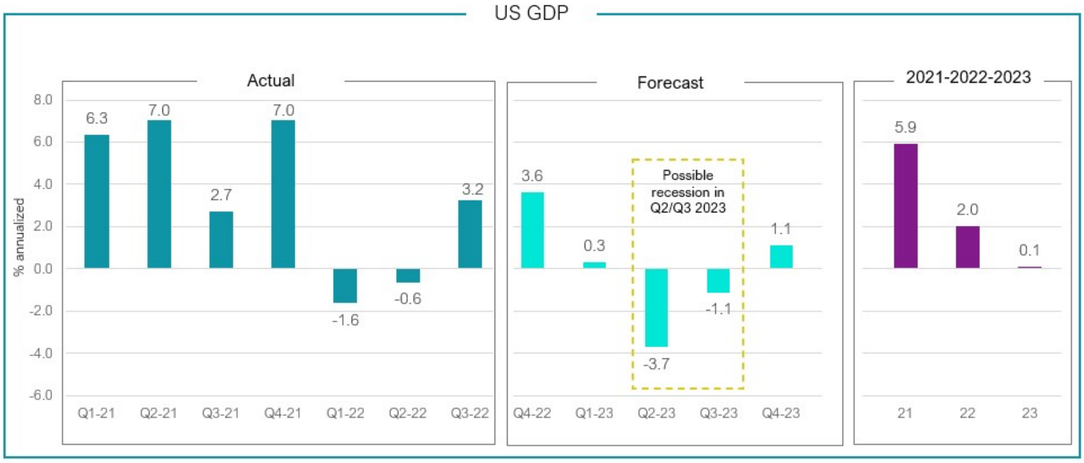
- The problem with a tight labor market is that it feeds into wage gains. While today's wage gains, as measured by average hourly earnings, have come down to 4.6% year on year from 5.1%, they are still too high. The Fed worries that today's wage gains potentially feed into tomorrow's service side inflation.

- Today the federal funds rate is around 4.5%. Market-based expectations see another 0.75% of further tightening to a terminal rate of 5.25%, even if the size and pacing of rate hikes slow from here. In prior tightening cycles back to 1974, the Fed funds rate needed to rise above the level of inflation before the Fed could successfully pause. We still have further to go.



Source: Historical data – Piper Sandler (June 2022); Current data – Federal Funds rate and December CPI data

- Ongoing monetary tightening impacts economic and earnings data with lag. A slowdown is coming, though it's too early to tell its magnitude and impact on the economy and earnings.
- However, it could be that in Q2 and Q3 of 2023 the US experiences a recession (defined as two quarters of negative GDP growth) as shown in the chart below. The severity of decline remains to be seen.



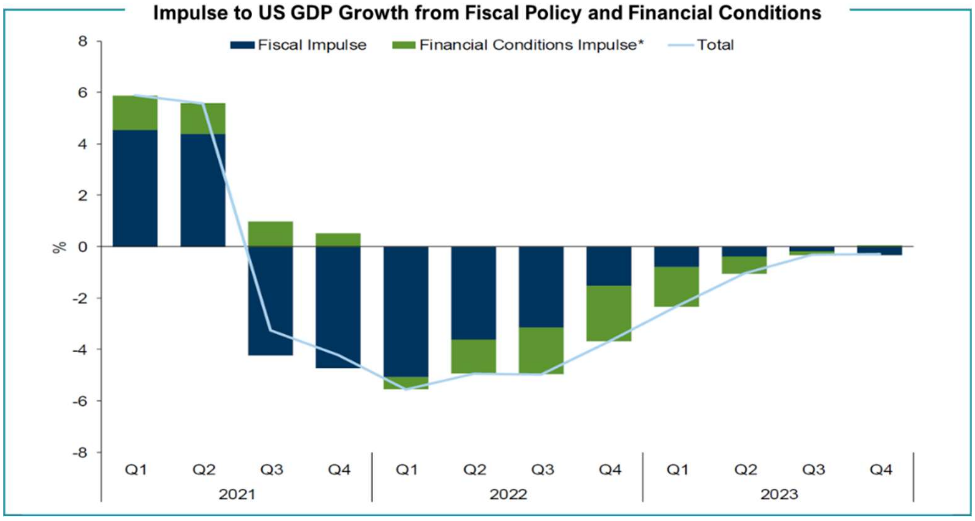
Source; Oxford Economics, January 2023

- If economic growth slows or contracts by this magnitude in the US, then we should expect a deceleration in earnings. Although consensus estimates are still for positive earnings growth, forecasts vary widely with many strategists predicting earnings to decline by 8-10% this year.

Medium-term constructive

- Close to 80% of economists currently expect a US recession to begin in the second quarter. As famous economist Paul Samuelson once quipped: "*Economists have predicted nine out of the last five recessions."* The consensus is not always right.
- Given the strength of the US economy and recent lower readings in inflation, it may be that the Fed can get close to achieving its inflation target without the US economy entering a recession.
- The US consumer remains relatively strong, with recent data signalling real consumer spending growth of around 3% annualized in Q4. Additional stimulus from the Inflation Reduction Act, Build Back Better, and CHIPS Act will start to be felt in 2023. Fiscal policy is much less negative to growth in 2023.

Fiscal policy and financial conditions are more supportive



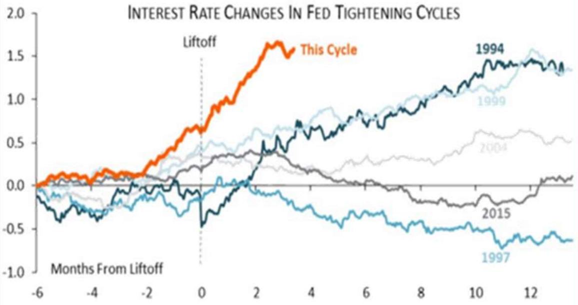
Source; Goldman Sachs (Caution: Heavy Fog) January 2023.

- Growth outside the US may also be strong. As China has eased its Covid restrictions, we expect a reacceleration of growth aided by government stimulus. China could add positively to global growth as it did in 2003, 2009, and 2016.
- Europe has experienced its mildest winter on record and economic growth is proving to be more resilient than expected. Europe's largest export market is China, thus there is additional benefit from improving conditions in China.
- These factors can support global earnings upside versus expectations in 2023.
- Recession or not, we believe that at some point inflation should ease enough to allow the Fed to end or partly reverse its rate tightening cycle.
- This has been the fastest rate tightening cycle since 1994 and one in which growth in money supply (M2 growth) has slowed sharply. History has shown that when M2 growth slows precipitously, inflation also tends to ease after some lag.

Key indicators signal lower inflation ahead

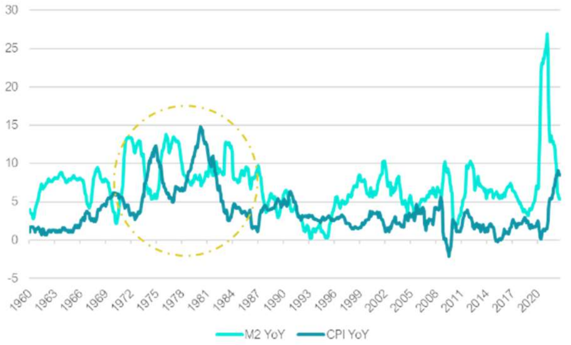
We are going through the fastest tightening cycle since 1994

Based on a composite index of various interest rates that affect the US economy, included are government interest rates, corporate interest rates (commercial paper and bonds of various credit quality), and consumer interest rates (mortgages, auto, and personal loans).



CPI usually follows M2 growth with a lag

One measure of how tight financial conditions is money supply growth, known as M2, which is slowing sharply and has now declined as measured from March (year-on-year) for the first time since the Second World War. **History shows that when M2 slows, inflation falls with a six-month lag**

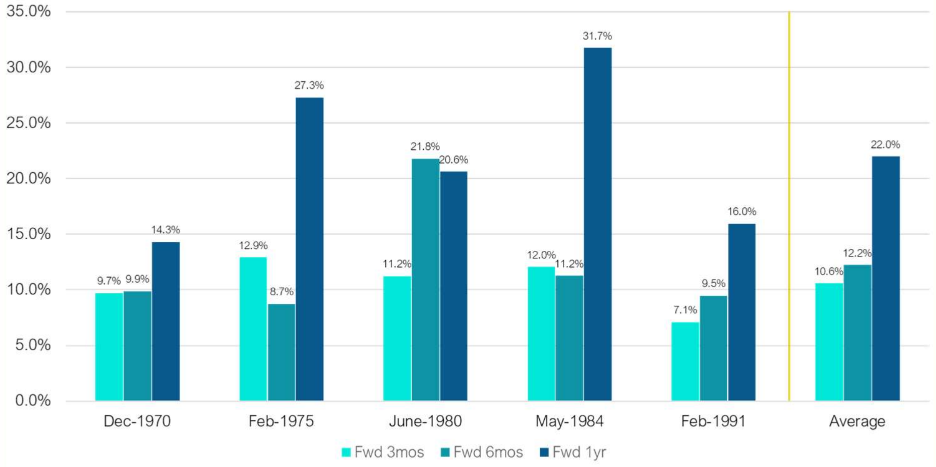


Source: Bloomberg LP & Piper Sandler, Longview Economics

- A pause in Fed tightening could be the trigger for a sustainable rally in risk assets.
- If history is a guide, peaks in US inflation (when the Fed pauses) have typically coincided with equity market bottoms.
- S&P forward returns three, six, and twelve-months following inflation peaks since 1958 were positive, with median returns of 10%, 12%, and 22% respectively.

The S&P Forward Return after Inflation Peak (since 1958)

- If history is a guide, peaks in US inflation have often marked equity market bottoms
- S&P forward returns three, six, and twelve months following inflation peaks since 1958 were positive, with median returns of 10.% (three months), 12.2% (six months) and 22% (one year).



Source: Bloomberg LP, 22V Research

Looking forward – asset allocation positioning

A different investing environment ahead

- Our view is that the Fed may get inflation lower, but it will likely remain structurally higher due to deglobalization, the onshoring of supply chains, and underinvestment in key supplies and commodities needed to support the energy transition.
- While we believe that central banks will be successful in easing the abnormally high levels of inflation that we have experienced post-Covid, we think inflation could prove sticky in the 3%+ range.
- The world may be entering a new global state where national interests eclipse policies based on pure economic efficiency. We think we have entered more of a 'Beggar Thy Neighbor' world.
- Both public and private fixed income have become more attractive than in the past decade and will likely become even more so. This asset class will likely be a greater source of both income and portfolio diversification, the latter as its correlation to other assets falls.
- Inflationary regimes have tended to favor different types of equities than disinflationary periods, with many of these types of shares trading at attractive valuations after underperforming over the past decade. We suspect that some unloved parts of the market such as international, value, and small/mid-cap equities may surprise on the upside in terms of relative performance and hence have begun to add certain portfolio tilts to reflect that view.
- Alternative asset classes can potentially provide further upside return and increased diversification:
  - Private equity: Private equity can provide access to long-term secular growth themes, many of which cannot be accessed in public markets. Private equity has historically been able to deliver more than twice the return of public markets over a long-term timeframe[v].
  - Real estate and real assets: Real estate has fared well in past higher inflationary environments as investors flock to real assets with inflation protection. We particularly like exposure to real estate with long-term secular supply/demand imbalances such as housing, industrial and retail storage, industrial parks, and last-mile e-commerce fulfilment.
  - Hedge funds: We believe the decade ahead will see significant increases in asset class volatility. Managers who can benefit from rapid changes in market direction and have the ability to identify associated market inefficiencies should be able to provide interesting and alternative sources of return.

Our themes are summarized in the chart on the next page.

Every decade has its winners – what will be next?

Decade of 2000-2008

Technology bust, building of China, engine of growth: heavy industrial investment & commodity demand led

- Inflation higher, going lower coming off Fed tightening
- High interest rate volatility
- High commodity prices
- Weakening USD

Outperformance:

- Value over growth
- U.S. small over large capitalization
- Non-US over U.S.
- Commodity & industrial sectors
- Emerging markets

Decade of 2008-2021

Decade of fiscal austerity, loose money. Interest rate & volatility suppression, tepid GDP, low investment

- Inflation low and fears of deflation
- Interest rates low & going lower
- Commodity prices falling
- USD stable to strong

Outperformance:

- US large cap growth over value & Non-US
- FAANGM technology leads – delivers growth
- Global bonds
- Bond proxies
- Dividend yields

Decade of 2022 - ?

Beggar thy neighbor world, resilient or onshoring supply chains, energy transition, structural shortages

- Inflation structurally higher (3-4%)
- Interest rates remain high and volatile
- Commodity prices remain high
- USD lower at some point?

Possible beneficiaries?

- Fixed income back in favor
- Within equities
  - Adding a value tilt
  - US mid (domestic) cap
  - Non-US markets do better
  - Energy and energy infrastructure
- Alternatives: private markets, hedge funds & real estate

Asset allocation positioning

As we think about how these trends impact our **stability, diversified** and **growth** strategy categories, we find more fertile ground for diversification than in the past. Some of the trends we are interested in from a portfolio perspective include:

Stability assets

- We believe 10-year **US Treasury yields** will settle in at around the 4% range, with high-grade corporate credit providing even higher returns. If inflation comes down to around 3%, as we suspect, we think real yields of 1%+ are attractive.
- Remember stability positions serve as a ballast to riskier assets. On a risk-adjusted basis, current yields on **inflation protected bonds, high-grade government and corporate** bonds are more attractive than they have been in more than a decade.

Diversified assets

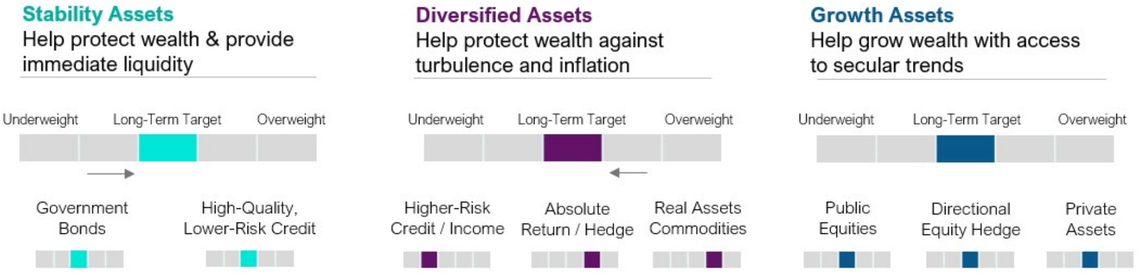
- **High-yield corporate bonds** are now attractive in absolute terms. We have a range of dynamic credit managers who can move up and down the credit spectrum as price dislocations in fixed income occur, giving us opportunistic higher yielding exposure.
- We continue to think that markets will remain volatile, favoring **absolute return strategies.** Many of these managers fare particularly well when markets are turbulent and changes in direction occur.
- We like **real assets** such as gold and, for clients able to accept a degree of illiquidity, various forms of quality real estate particularly in areas of deficit supply. Real estate can provide a natural inflation hedge, with attractive, sustainable, and tax-efficient income.

Growth assets

- In public equities, we have a few portfolio tilts in addition to our broad-based market exposure that we think will outperform as markets recover:
    - We have an allocation to the mid-cap sector in the US as we expect these types of companies to benefit from earnings uplift from the onshoring of US manufacturing activity. Mid-caps also trade at a substantial discount to US large capitalization companies.
    - We have added exposure to value-oriented quality equities, focused on quality companies that are showing an improving return on capital invested and free cash-flow generation and that trade at a substantial discount to growth shares. We think these types of shares can provide both diversification and additional upside from growth and multiple expansion, which is not currently reflected in their valuations.
    - Finally, we are adding exposure to non-US equities. The US dollar has risen in prior periods of extreme tightening as we experienced last year, such as during both the Volcker and Greenspan tightening eras. Once the Fed stopped raising rates and pivoted to an easier stance, a multi-year period of US dollar weakness led to substantial outperformance of international markets vis-a-vis the US.
- In private markets, our focus is to leverage our access and experience to partner with managers who add strategic and operational value to drive enhanced profitability. We continue to see ample opportunities to invest in long-term secular growth themes such as ongoing digitalization and innovation, the energy transition, and impact strategies that we think can deliver attractive long-term returns and make a positive difference in society. Historically, private equity tends to outperform in the periods following market dislocations.

Conclusion

In 2023, we will be much more balanced in terms of overall strategy risk exposure. Within strategy categories, our relative positioning through active managers and alternative investments should allow us to generate incremental returns, as summarized in the chart below.



Stability Assets
Help protect wealth & provide immediate liquidity
Underweight
Long-Term Target
Overweight
Government Bonds
High-Quality, Lower-Risk Credit
Diversified Assets
Help protect wealth against turbulence and inflation
Underweight
Long-Term Target
Overweight
Higher-Risk Credit / Income
Absolute Return / Hedge
Real Assets Commodities
Growth Assets
Help grow wealth with access to secular trends
Underweight
Long-Term Target
Overweight
Public Equities
Directional Equity Hedge
Private Assets

Stability assets are now more attractive. We have increased weight to the mid-range of our long-term target.

- **Rates on USD Treasury and TIPS:** rates have moved to levels that are attractive for excess liquidity.
- **Investment grade corporate bonds:** We favor an allocation to these bonds given their higher yields and ballast role in the portfolio.

Diversified assets continue to offer opportunity.

- **Absolute Return/Multi-Strategy:** We favor managers who benefit from market turbulence and have low correlation to equities.
- **Real Assets/Commodities:** largely gold, and real estate where appropriate, to client liquidity and tax circumstance.

Growth assets; looking at new long-term opportunities.

- **Public equities:** we like quality and raised our exposure to quality value and mid-cap in the US: we are increasing our RoW exposure. We have an allocation to the energy transition and energy infrastructure.
- **Private markets:** an important allocation to drive returns and access impact and long-term secular-growth themes.

[i] *Bloomberg LP, 31st December 2022.* ***Past performance is not a guide to future performance, nor a reliable indicator of future results or performance***

[ii] *S&P 500 Index to represent stocks and the Bloomberg Barclays US intermediate one-to-ten-year Treasury index for bonds*

[iii] *Source: Bloomberg LP, January 2023*

[iv] *Source: NDR, November 2022*

[v] *Source: Cambridge Associates, 30th June 2022. The 20-year US private equity index return was 14.79% versus its public market equivalent of 7.45%, as measured by MSCI gross total return. The PE index is a horizon calculation based on data compiled from 1,451 US private equity funds, including fully liquidated partnerships, formed between 1986 and 2022.*

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