January 20th, 2023

CURMI & PARTNERS

Monthly Strategy Update

The month in summary:

December was another difficult month for investors as the bond and equity markets we follow generated another month of negative returns. The US real yield climbed 24bp in December, the yield on the 10-year US Treasury Bond rose 27bp, whilst the German 10-year and UK 10-year yield increased 64 bp and 51 bp respectively. This in turn weighed on credit markets as EUR IG fell 1.8% and GBP IG lost 1.7% during the month. The move in US IG was less pronounced, falling 0.4% during December. Furthermore, global equities lost 4.2% following two consecutive months of strong performance. Finally, Natural Gas prices fell 35.4% during December mainly as a result of the warmer than expected weather (less demand) seen across Europe.

2022 in summary:

2022 was a challenging year for investors, dominated by the narrative around central bank policy and the tightening of monetary policy. Over the course of the year, inflation surprised significantly to the upside which necessitated an aggressive response by central banks. This surprised investors, as consensus was looking for 75bp rate hikes in 2022 across 3 meetings at the start of the year rather than the actual 425bp rate increases announced by the FED. Obviously, the delayed impact from these rate hikes on economic activity is a key risk for 2023.

The tightening of monetary policy during the year led to a significant rise in 10-year yields across regions we follow. The US Treasury yield surged 236bp to 3.9%. Also, the yield curve remains inverted, with the 2-year Treasury yielding 4.3% at the end of the year, which is generally considered to be an early sign of an upcoming recession.

Bonds and equities both sustained losses during 2022, generating the worst returns of a 60/40 portfolio since 1969. The Euro IG market lost 13.6% and the Euro HY lost -11.1% compared to losses of 10.6% for the European equity markets. Although inflation worries and uncertainty over central bank action drove performance last year, we expect the narrative to shift to recession concerns in 2023.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	27	236
DE 10-year yield	64	275
UK 10-year yield	51	270
Credit		
Total return	MoM %	YTD %
EUR IG	-1.8%	-13.6%
EUR HY	-0.9%	-11.1%
USD IG	-0.4%	-15.8%
USD HY	-0.6%	-11.2%
GBP IG	-1.7%	-19.3%
GBP HY	0.2%	-10.6%
Equities		
LCL Total returns	MoM %	YTD %
S&P 500	-5.8%	-18.1%
Nasdaq 100	-8.7%	-32.5%
STOXX 600	-3.4%	-10.6%
DAX	-3.3%	-12.3%
CAC	-3.8%	-6.7%
FTSE 100	-1.5%	4.6%
Emerging markets	-1.5%	-19.9%
EM ASIA	-0.3%	-19.6%
EM LATAM	-4.0%	8.9%
EM EMEA	-3.1%	-28.1%
Currencies		
Total return	MoM %	YTD %
EURUSD	2.9%	-5.8%
EURCHF	0.6%	-4.6%
GBPEUR	-2.5%	-5.0%
GBPUSD	0.2%	-10.7%
Commodities		
Total return	MoM %	YTD %
Oil WTI	-0.5%	16.7%
Oil Brent	-1.2%	19.2%
Natural Gas	-35.4%	20.0%
Gold	3.1%	-0.3%
Copper	1.6%	-13.9%
Iron Ore	14.2%	33.1%
Lumber	-13.0%	-67.4%

Robert Ducker, CFA
+356 23426112

Edward Attard
+356 23426113

Simon Gauci Borda
+356 23426132

Nicole Busuttil
+356 23426126

Macro-economic views

Global economic growth slowed through 2022 on a diminishing reopening boost, fiscal and monetary tightening, China's COVID restrictions and property slump, and the Russia-Ukraine war. Emerging economies have historically outpaced developed economies, but the divergence in growth has narrowed over the past two years. Consensus expects emerging economies to grow at 3.1% in 2022 compared to 2.7% for developed economies, or a variance of 0.4%. This compares with a 5-year median (2017 to 2021) of 2.7%. The same median average of 2.7% is arrived at if we exclude the COVID-19 hit years (2015 to 2019).

This narrowing in the growth gap between developed and emerging economies was primarily driven by a slowdown in the latter. Developed economies expected growth in 2022 of 2.7% which is above the 2.3% median for the period 2017 to 2021. Yet, expected growth in emerging economies of 3.1% in 2022 is well below the median of 5.0% during the same period. In our opinion this highlights China's importance from an economic perspective for emerging economies. China's economic woes have led to a slowdown from a median economic growth of 6.7% (2015 -2019), down to 3.0% expected by consensus in 2022. Therefore, any improvement in China's economic fundamentals should boost global economic growth in the future.

Economic growth in 2023 is expected to slow down significantly, mainly as a result of the aggressive tightening over 2022. Consensus expects global growth of 2.1%, with developed economies slowing down to 0.4% in 2023 (down from 2.6% expected in 2022) whilst emerging economies accelerating to 3.9% in 2023 (up from 3.1% expected in 2022). However, recent news flow has been positive. Firstly, the resilient labour market in the US where wage growth is slowing without a significant uptick in unemployment bodes well for 2023 growth. Secondly, the milder than expected weather in Europe and the China re-opening should boost growth in the region.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Expectations for developed economies have been revised lower over the past month, with growth of just 0.5% expected in FY23

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F (New)*	*FY22F*	*FY23F*	*FY24F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F (New)*	*FY22F*	*FY23F*	*FY24F*
United States*	1.1	0.1	-0.6	0.0	0.9	1.5	1.8	1.9	0.3	1.3	0.6	0.1	-0.5	-0.6	-0.1	-0.1	0.1	-0.1	0.0
Japan*	2.9	0.7	0.9	0.9	1.2	1.1	1.2	1.4	1.2	1.0	0.1	-0.3	-0.2	0.0	0.0	-0.3	-0.1	-0.1	-0.1
Germany	0.6	-0.8	-0.8	-0.9	0.1	0.9	1.3	1.7	-0.6	1.2	0.1	0.1	-0.1	-0.2	0.1	-0.2	0.0	0.0	-0.1
France	0.2	0.3	-0.1	-0.1	0.5	0.8	1.1	2.5	0.2	1.1	0.0	-0.1	-0.1	-0.3	-0.2	-0.6	0.0	-0.2	-0.1
Italy	1.3	0.7	-0.4	-0.6	-0.1	0.7	1.0	3.8	0.0	1.0	0.1	0.1	0.0	-0.3	-0.3	-0.3	0.1	0.1	0.0
Spain	1.4	1.4	0.3	0.6	1.3	1.9	2.0	4.5	1.0	1.9	0.0	0.1	-0.1	0.0	-0.1	-0.1	0.0	0.0	0.0
Eurozone	1.3	0.3	-0.5	-0.4	0.3	1.3	1.5	3.2	-0.1	1.4	0.2	0.3	0.1	0.0	-0.1	0.0	0.0	0.0	-0.1
UK	0.4	-0.7	-1.3	-1.2	-0.9	0.0	0.6	4.4	-1.0	0.9	0.2	0.2	0.2	-0.1	-0.2	-0.3	0.2	-0.2	-0.1
Developed Economies	1.3	0.3	-0.3	0.1	0.8	1.4	1.6	2.6	0.4	1.4	0.3	0.0	-0.3	-0.3	-0.1	-0.1	0.0	-0.1	-0.1
China	2.9	3.1	6.7	4.4	5.0	5.1	4.8	3.0	4.8	5.0	-0.9	-0.5	-0.1	0.0	0.6	0.4	-0.3	-0.1	0.1
Emerging Economies	2.5	2.5	5.0	3.8	4.3	4.6	4.6	3.1	3.9	4.4	-0.5	-0.2	0.0	0.0	0.2	0.2	0.0	-0.1	0.0
Global								3.2	2.1	2.9							0.3	0.0	0.0

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Consumer prices, YoY %	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F (New)*	*FY22F*	*FY23F*	*FY24F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F (New)*	*FY22F*	*FY23F*	*FY24F*
United States	7.3	5.9	4.0	3.3	3.0	2.8	2.6	8.0	4.0	2.5	-0.2	-0.3	-0.4	-0.4	-0.1	0.0	-0.1	-0.3	0.0
Japan	3.8	2.6	2.3	1.7	1.2	1.4	1.0	2.4	1.8	1.0	0.3	0.1	0.4	0.5	0.2	-0.1	0.0	0.2	0.0
Germany	11.4	9.7	7.5	6.1	3.4	2.6	2.5	8.8	6.5	2.6	0.1	0.1	-0.1	0.0	-0.2	0.0	0.2	0.0	0.1
France	7.2	7.0	5.5	4.8	3.5	2.5	2.1	6.0	5.1	2.3	0.0	0.3	0.1	0.2	0.0	0.1	0.1	0.2	0.0
Italy	12.0	8.9	7.7	5.8	2.6	2.4	1.8	8.6	6.6	2.0	0.3	-0.4	0.0	0.1	0.1	0.3	0.3	0.6	0.1
Spain	7.5	5.9	4.9	3.5	3.6	2.6	2.0	8.5	4.5	2.3	-0.2	-0.7	-0.3	-0.1	0.1	-0.1	-0.2	-0.1	0.1
Eurozone	10.3	8.7	6.8	5.4	3.5	2.6	2.2	8.5	6.1	2.2	-0.2	-0.3	-0.1	-0.1	0.4	0.1	0.0	0.2	0.1
UK	10.8	10.2	7.9	6.6	4.4	3.9	2.5	9.1	7.2	2.5	0.3	0.3	0.4	0.1	-0.2	0.1	0.1	0.2	-0.1
Developed Economies	9.2	7.5	5.7	4.7	3.8	3.4	3.0	8.6	5.3	2.8	0.0	-0.2	-0.1	-0.1	0.0	0.1	0.1	0.0	0.0
China	2.2	2.6	2.2	2.2	2.2	2.0	2.1	2.1	2.3	2.2	-0.4	-0.2	0.0	0.0	0.2	0.0	-0.1	0.0	0.1
Emerging Economies	6.7	6.5	5.4	5.1	5.0	4.6	2.9	6.4	5.8	4.2	-0.2	0.0	0.1	0.1	0.1	-0.1	0.0	0.2	0.0
Global								8.8	5.2	3.3							1.3	0.1	-0.1

Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR

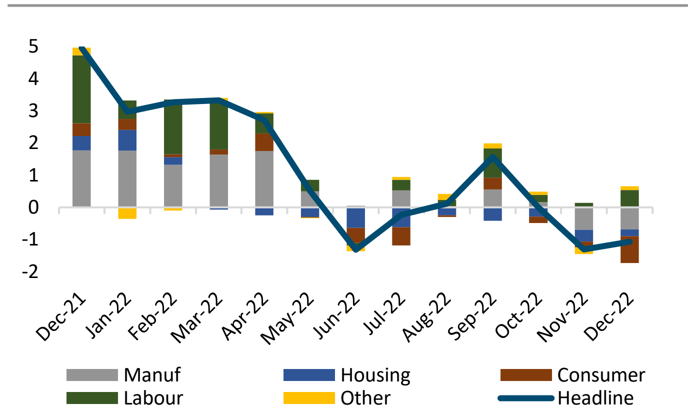
United States

Growth: Real GDP was revised higher to 3.2% YoY in 3Q22, better than the 2.9% in the second estimate. This was driven by firmer services consumption growth (+0.6pp to 2.3%) led by services (+1.0pp to 3.7%), which more than offset lower inventory investment (-1.2pp contribution to GDP growth vs -1.0pp previously). The final estimate is just above the Atlanta FED GDPNOW estimate for Q3 of 3.1% as at the last forecast date (26 October). Economic activity in December has recovered slightly from the prior month. The headline Current Activity Indicator (CAI) for December is of -1.1 (Exhibit 2), a slight recovery from the revised November headline CAI of -1.3 (Exhibit 13). Labour CAI and Other CAI saw a significant recovery, improving by +0.4 and +0.3 respectively. However, this was offset by a significant negative move in the Consumer CAI of -0.7.

Inflation: December core CPI rose 0.3% MoM, in-line with consensus expectations (Exhibit 4). This suggests that inflation pressures in the US are easing, with December marking the third consecutive month of slower inflation. Also, the most important aspect of the US December employment report was the muted 0.3% increase in average hourly earnings. Helped by downward revisions to past data, annual wage growth dropped back to 4.6% – its lowest since mid-2021 – with the three MoM annualised rate at only 4.3%. The Atlanta FED wage growth tracker fell to 6.1% in December, down from 6.4% in November, whilst the job-workers gap climbed slightly to 4.7 million (Exhibit 5).

Exhibit 2 – US Current Activity Indicator

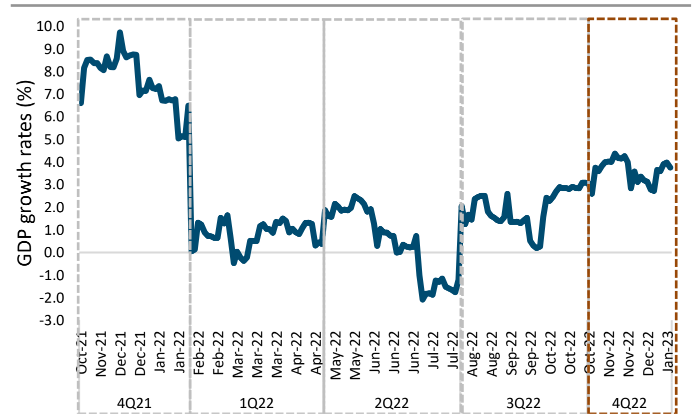
Economic activity continued to fall in November, with weakness mainly driven by Manufacturing CAI…



Source: Goldman Sachs

Exhibit 3 – Atlanta FED GDP estimate

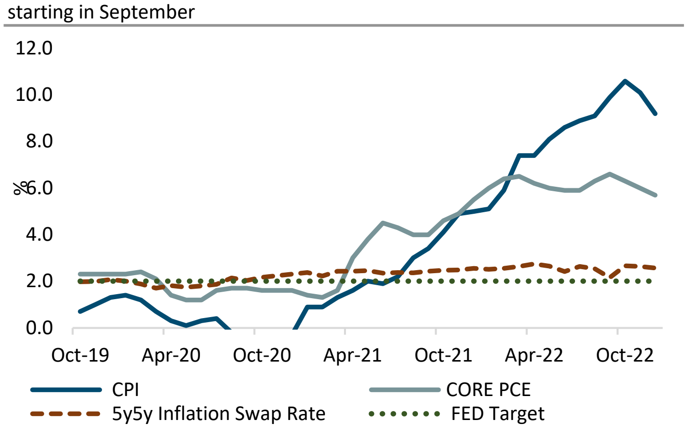
The Atlanta FED growth forecast 4Q22 has improved from +2.8% at the start of December to +3.8% in January 2023



Source: Atlanta FED

Exhibit 4 – US Inflation rate

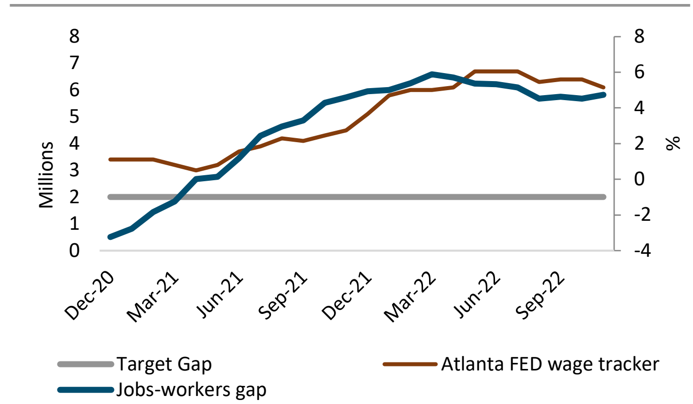
Core inflation has been on a downward trend for the past 3 months starting in September



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)

The jobs-workers gap climbed slightly in December as the number of unemployed (-278k) fell by more than job openings (54k)



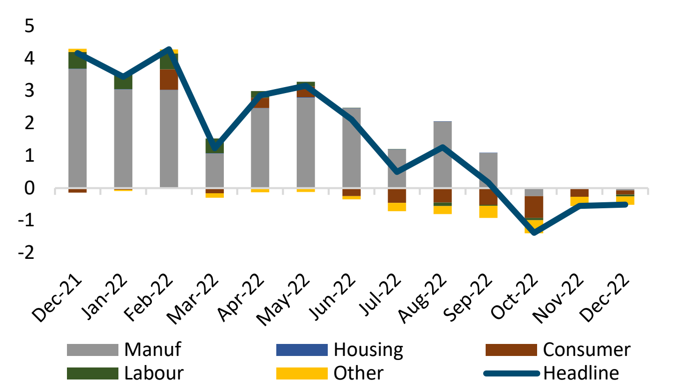
Source: FRED, Atlanta FED

Europe

Growth: The growth story for Europe has improved over the past weeks despite the softness in the most recent business surveys. On balance, hard economic data has held up surprisingly well in 2022 given the massive negative impact from the energy crisis. Currently the region's economy is benefiting from two positive shocks: (1) warmer than expected weather (which has pushed wholesale natural gas prices below pre-war levels) and (2) the China reopening. Consequently, the bounce in business expectations seen in the most recent PMIs may have further to run, with rising probability that a recession in 2023 can be avoided. The milder weather could boost household real income, although we note that temperatures could still drop in the coming months. Also, the summer re-fill season will be impacted by inventory levels after the summer (less usage implies higher inventory levels and less refill requirements), which could be tougher this year due to the added pressure on price from higher Chinese demand.

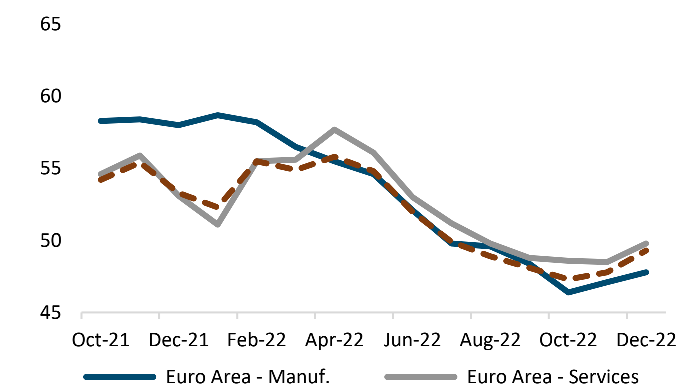
Inflation: In the flash inflation release for December, Euro Area headline HICP inflation fell 85bp to 9.2% YoY, below expectations of 9.7%. Core HICP inflation rose 19bp to 5.2% YoY, slightly above expectations of 5.0%. The fall in inflation was driven by a drop in energy inflation from 34.9% to 25.7%, in part driven by the mild temperatures in Europe which resulted in less demand for electricity (namely heating).

Exhibit 6 – EU Current Activity Indicator
Economic activity seems to have picked up somewhat during November, following three consecutive months of deterioration…



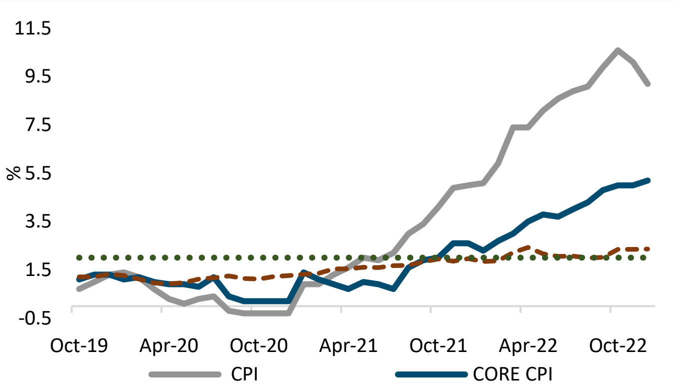
Source: Goldman Sachs

Exhibit 7 – EU PMIs
…which was also evidenced in PMIs, where the composite reading came in ahead of expectations



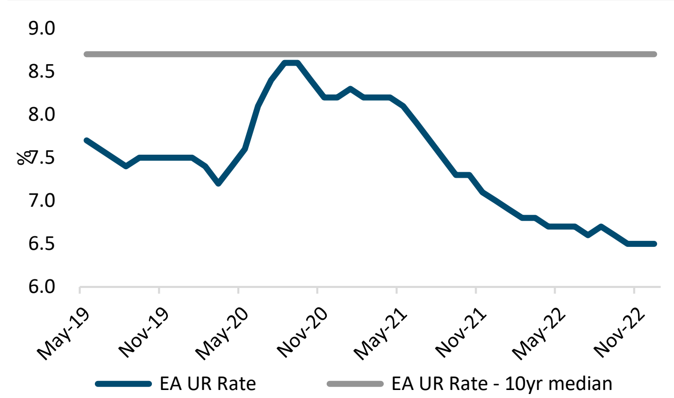
Source: Bloomberg

Exhibit 8 – EU Inflation rate
Headline inflation moderated during October to 10.0% (from 10.6%) but core prices continued to rise (6.6% vs 6.4%)



Source: Bloomberg

Exhibit 9 – Euro-area unemployment rate
…with unemployment still well below 10-year median

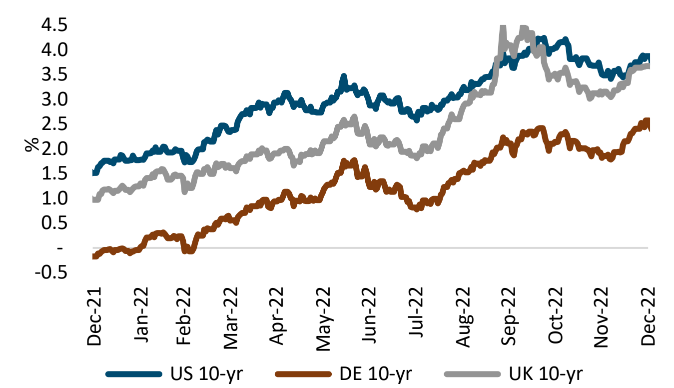


Source: Bloomberg

Rates

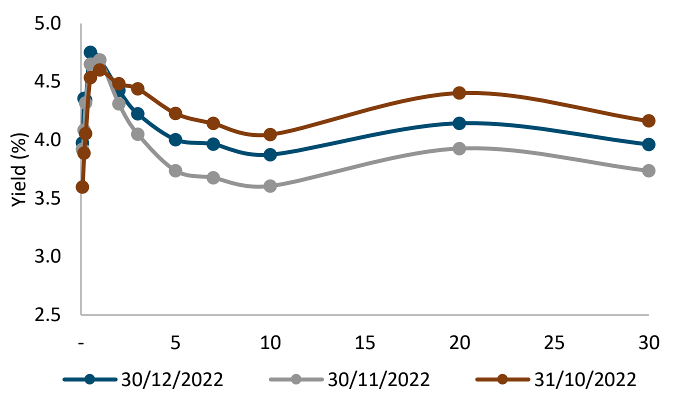
Volatility in the rates markets persisted during December as investors weighed comments made by central bankers and macro-economic data. The higher probability of a slowdown in the hiking cycle led to a pullback in yields that started in November and persisted till mid-November. The softer inflation print in the US reinforced investor beliefs that an inflation peak had been reached, which was interpreted as a sign that central banks would be able to cut rates in 2H23. Yet, we note that inflation remains well above target, which makes a rates cut in 2023 very unlikely unless something breaks.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
The lower than expected US inflation print for October led to a downward move in nominal yields across the countries we follow



Source: Bloomberg

Exhibit 11 – US Yield Curve
US yields have remained largely unchanged at the short-end of the curve, but have increased at the belly and long-end



Source: Bloomberg

United States

The FED's decision to slow down the pace of rate hikes did little to quell the sell-off in Treasuries during the month of December as the yield on the ten-year reached 3.9% by the year's end, rising from a mid-December low of 3.5% after a 100bp pullback since October (20/10). While inflation data released in December did show a slow down in the rate by which prices increased, the FED remains committed to further rate hikes in upcoming meetings in order to bring the rate of inflation down further. For the time being, markets are ignoring the recently published dot plot and the Fed's persistence to hold rates at high levels.

Economic data will probably be mixed during the first half of 2023, which is generally interpreted by the market as raising the probability of a recession, consequentially leading to a higher market-implied probability of a FED rate cut. However, caution is urged on overinterpreting the data as (a) despite the slowing wage pressure, policy restraint is set to fade this year and an anticipated rebound in real disposable income will likely mean a stronger than desirable growth rebound if the FED allows a premature easing of financial conditions (b) on the activity data, weakness appears to be concentrated in the softer survey based data as opposed hard data and there are periods when the two have diverged where soft data eventually rebounded and (c) the recent FOMC meeting suggested that no FOMC member was expecting to cut rates this year even alongside forecasts for a material increase in the unemployment rate.

Europe

Slowdown in inflation did little to bring down Euro Area rates in December as the Bund touched a low of 1.8% in early December following the release of German inflation figures, rising thereafter to 2.6% by year-end. During the month, the ECB hiked rates by a further 50bp which was in-line with consensus expectations, and a slowdown in the pace of hiking from the 75bp rate hike in the previous meeting. Yet, the tone adopted by the ECB President during the December meeting was more hawkish than expected by markets.

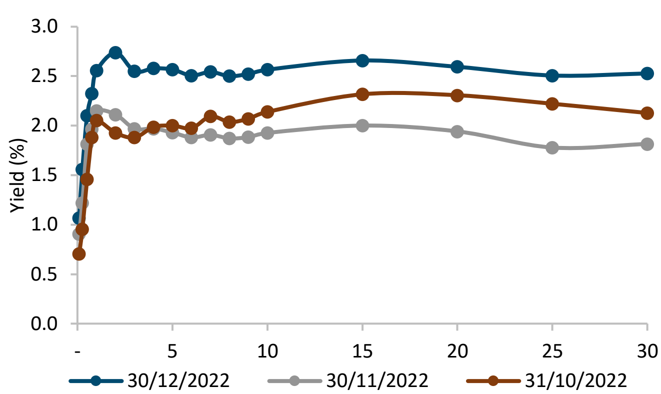
President Lagarde noted that the ECB is far from done with hiking rates as she warned markets that they should not expect an early end to rate rises in 2023, warning that the ECB has “more ground to cover” than the FED. In fact, she also noted that the ECB will be hiking rates by a further 50bp at its next two meetings to be held in February and March. Furthermore, Lagarde noted that the ECB will begin shrinking its balance sheet from March via the passive run-off of its APP portfolio.

In the UK, the 10-year Gilt yield rose in December following the Bank of England’s decision to hike rates by 50bp, in-line with market expectations. MPC members voted 6-3 to hike rates by a further 50bp in December with two external members voting not to raise rates at all with another voting to hike rates by a further 75bp. The 50bp hike was driven by the tightness in the UK labour market and the persistence of domestic price pressures which together justified a “further forceful monetary policy response”. Going forward, the BoE is set to take a meeting-by-meeting approach with respect to further rate hikes. The 10-year Gilt yield closed the year at 3.7%, which represents a 51bp increase from the end of November.

The Government’s pledge to lower household’s energy costs could lead to higher issuance of sovereign debt during 2023, which could in turn lead to higher yields (higher required return by investors due to higher debt levels). However, we note that the warmer than expected weather that has led to significant fall in gas prices, could lead to lower issuance than previously anticipated, if such lower prices persist. At the other end of the spectrum, the elevated price pressures in the UK could lead to more rates anxiety going forward.

Exhibit 12 – German 10-year yield curve

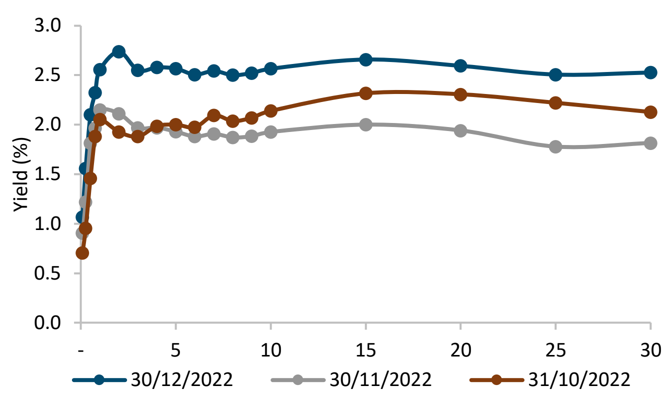
German yields also moved lower following the October inflation miss seen in the US, despite not signs of an inflation peak in Europe (till 30/11)



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve

Yields continued to fall after the September shock brought about by the budget announcement



Source: Bloomberg

Credit

We see 2023 as the year in which markets move away from a world of coping with rate hikes to living with the consequences of higher rates – or in other words, undergoing a transition from the dominant driver of market moves shifting from rates to economic volatility. Given the surprisingly hawkish statement from ECB President Lagarde at the last ECB meeting of 2022, it is clear that this transition will take time, with a 50bp hike still expected in February and in March (versus 25bp for the Fed and BoE), and for APP reinvestments to be halved from March and halted altogether in June. The base case for the year, as a whole, is that things will likely get worse before they get better. Rates volatility will arguably be with us in the medium term, and we expect central banks to hike regardless of clear recessionary signals and weak earnings, which would be a challenging backdrop for the markets. Though as the year progresses, the expectation is for rate volatility to drop significantly and for a shallow recovery to emerge by end-2023 which should allow markets some room to trade better.

The strongest counter to this narrative is the view that as inflation numbers will likely be dropping consistently in the beginning of the year, it will be hard for markets not to rally, particularly within IG credit. Similarly, investors may simply look through a “brief” recessionary period and price markets for the expected longer-term dynamics, preventing a sharp sell-off. Conversely, concerns around sticky inflation or the risk of an even deeper recession is problematic for Europe, as this could make for even higher rates which would pressure BTPs even more, a risk which European credit markets may not be fully appreciating following the recent rally. The key point to consider however, is that we will likely not know whether we are in the “sticky inflation” scenario until much later in 2023.

We remain constructive on IG credit entering 2023, despite the year end rally. Macro challenges persist, though the wides for this cycle are most likely behind us. We recommend positioning for rating compression in the 5-7 year area and favour financials, whilst remaining wary of CSPP-eligible bonds. Given the ECB’s announcement at its December meeting of a more meaningful slowdown of APP reinvestments in 2023 than had originally been anticipated, the persistent richness of CSPP-eligible bonds appears unfounded. Expectations are therefore for this CSPP premium to decrease (in absolute terms) during 2023, and for eligible bonds to underperform.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit

	31/12/2022	30/11/2022	31/12/2021	MoM Δ	YTD Δ
Total Returns (%)					
EUR IG	227.66	231.77	263.64	-1.77%	-13.65%
EUR HY	389.15	392.59	437.87	-0.88%	-11.13%
USD IG	2968.20	2981.28	3523.57	-0.44%	-15.76%
USD HY	2186.03	2199.76	2461.43	-0.62%	-11.19%
GBP IG	249.94	254.34	309.61	-1.73%	-19.27%
GBP HY	796.05	794.44	890.43	0.20%	-10.60%
	31/12/2022	30/11/2022	31/12/2021	MoM Δ	YTD Δ
Spread Movements (bps)					
EUR IG	167.45	181.40	94.99	-13.95	72.46
EUR HY	512.29	525.81	318.01	-13.52	194.29
USD IG	130.12	132.84	92.37	-2.72	37.75
USD HY	468.65	447.57	282.98	21.08	185.67
GBP IG	193.77	205.54	113.77	-11.77	79.99
GBP HY	691.53	697.57	375.68	-6.04	315.85

Source: Bloomberg

At their December 15th meeting, the Governing council of the ECB announced the end of APP reinvestments starting in March. The average monthly runoff pace will initially be set at €15bn for the period from March to June 2023, followed by an uncapped passive runoff of the APP portfolio thereafter. While the announcement was hawkish, both in terms of the timing and the pace of the runoff, we continue to think the impact of ECB QT will be much more manageable for Euro IG corporate bonds than for sovereigns, mainly given the differing outlook for net issuance in both markets. As a result of these different dynamics, net supply available to private investors is expected to increase dramatically in the sovereign space, particularly in the BTP market, whilst by contrast the Euro IG market, with gross issuance slowing and an expected pickup in fallen angels this year, the expectation is that the net supply that the private market will have to absorb will decline meaningfully.

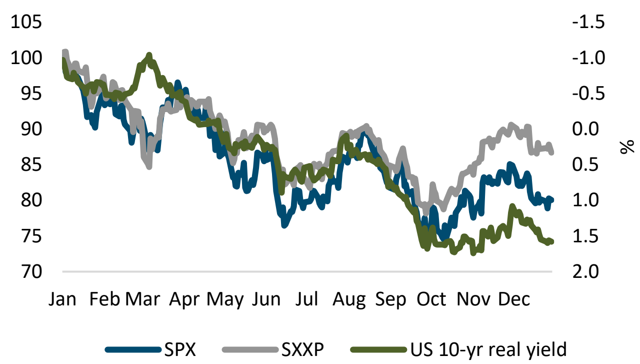
US corporate fundamentals have more recently been deteriorating, with signs pointing to further pressure. A mix of unfavourable growth prospects, FX headwinds, margin pressures, and less constructive leverage trajectories are weighing on corporate fundamentals at a time when cash balances have also been falling rapidly, primarily to buy back shares. In the end, slower growth and tighter financial conditions could lead to more rating downgrades and fallen angels from very low levels. On the trading side of things, tight starting spreads at this stage in the late cycle imply a greater risk of widening, although yields are near decade highs and bond prices do remain low as a result of weakness in treasuries. Investment grade spreads have not traded below 150bp on a sustained basis in a late credit cycle/recessionary period when manufacturing PMIs were below 45. Similarly, PMI below 45 historically implies high yield spreads above 650bp. When coupled with tighter lending standards, the implication is for potentially significantly wider spreads. That said, spreads are not far from their long-term median, suggesting pricing is more in line with middle cycle than late cycle and would be dependant on the length and depth of a recession. Against this negative valuation backdrop, we can at least point to high all-in-yields and low bond prices (supported by higher yielding treasuries) to provide technical support. Given the shape of the USD spread curve, we believe the 5 year part of the curve looks most attractive from carry perspective given a historically steep 3s5s curve, though are conscious that the extreme shape of the treasury curve can skew favour closer to the front end.

In sterling, credit markets had to contend with two idiosyncratic shocks in 2022. The first was the active sales of CBPS holdings by the Bank of England, and the second was the LDI crisis. While the combination of these factors has led to sharp underperformance, the upside is that they have helped to reset valuations in £-IG. The poorly judged mini-budget of the short-lived Truss government caused a sharp repricing in gilt real yields that subsequently triggered a waterfall of margin calls and liquidation flows by the UK pension fund community. The process quickly became self reinforcing, prompting the BoE to intervene with the emergency purchase of long-end gilts, as well as suspending its plans to sell gilts and corporate bonds. During those two weeks, there was substantial selling of gilts and corporate bonds, which put stress on £-IG. The new UK government has brought about a much-needed period of calm for the UK and sterling markets. But it has been at the cost of a fiscally austere budget, relative to earlier in the year and versus the US and Europe. In part because of this, the UK has some of the worst growth prospects in 2023, as well as being likely to see the highest inflation. Looking into 2023, we expect £-IG primary markets to remain functional, albeit at a relatively subdued levels, as the CBPS unwind continues to drip-feed bonds to investors. Given that the LDI crisis is now behind us, we have some form of normalcy within UK politics, and spread levels have been repriced notably wider, we have grown incrementally more comfortable on UK credit than we have been for the majority of 2022. Whilst acknowledging the poor macro backdrop, we feel that at current levels, more of these risks are appropriately priced in.

Equity

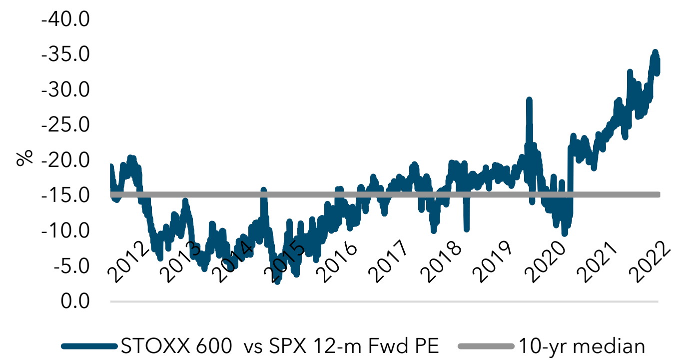
2022 was a challenging year for investors, with news flow dominated by uncertainty around central bank action. Inflation surprised sharply to the upside for most of the past year as labour markets tightened and supply-side constraints persisted. Central banks tightened policy at a much faster rate than previously expected with the FED raising rates by 425bp across seven meetings compared to 75bp across 3 meetings expected at the start of the year. It is also worth noting that in the summer of 2021 consensus was expecting no rate hikes throughout 2022. Bonds and equities fell together generating the worst returns for a 60/40 portfolio since 1969. We believe that inflation will remain a concern going into 2023, at least until the markets get more comfort that central banks have some control over prices.

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)
There is a clear negative correlation between real yields and equity market performance



Source: Bloomberg
Performance rebased from 31 December 2021

Exhibit 16 – SXXP 12-mth FWD P/E
Consensus seems to be more optimistic around Euro-area and China real GDP growth in 2023



Source: Bloomberg

The end of the easy money era came to an abrupt end last year. 2022 was a throwback in more ways than one. Firstly, investors had to worry about inflation probably for the first time since the 80s. Market sentiment was dominated by the leg upwards in interest rates and the impact across all financial markets. The FED raised rates by 425bp across seven meetings, leading to a sell-off in both bonds and equity markets. Secondly, the goldilocks era since the financial crisis was perfect for long-duration assets like the Nasdaq. Yet, the persisting high inflation led to a reversal in the pattern of returns with commodities outperforming and the Nasdaq the worst performing index. Finally, the invasion of Ukraine was an unwanted reminder of the unpredictability of the Soviet Union before its collapse in 1991.

The equity market performance was heavily influenced by the path for real rates (Exhibit 15). This relationship was especially strong over the first 9 months of 2022, when the move in yields closely mirrored the move in equities. During the fourth quarter, investors were encouraged by the higher possibility of a slowdown in the rate hike cycle. Also, investor sentiment around Europe improved on the higher probability of a China re-opening. On balance, this led to global equities rallying 9.9% (in US$ terms) while US real rates fell 10bp during 4Q22. We believe that equity market performance will still be influenced by inflation and interest rates in 2023, until it becomes evident that central banks have successfully tamed inflation. Also, the easing of financial conditions over the past months could force the FED and other central banks to higher peak rates than are currently being priced by the market.

The FTSE 100 was the best performing index in 2022, with a total return of +4.6% in local currency terms. The index's large exposure to the Energy and Banking sector boosted performance last year, even though risks to the UK's economy are rising. The US outperformance over Europe that lasted for most of the past decade came to an end. The S&P 500 generated a total return of -18.1% in US$ terms compared to -10.6% for the STOXX 600. Within Europe, Spain was the best performer (-2.0%) boosted by the high exposure to Energy and Financial Services. On the other hand, the high correlation to global growth weighed on German equities during 2022, with the index generating a total return of -12.3%.

The news flow so far in 2023 has been more supportive for equities. The warmer than expected weather in Europe and the China re-opening have led to a strong start to the year. Also the resilient labour market in the US should reduce investor anxiety around the possibility of a recession in the US. But we continue to urge caution over the short-term, as we expect volatility to remain elevated in the first six months of 2023 as we expect the narrative to shift away from inflation to growth concerns. The key known unknown is the lagged impact on the global economy from the aggressive tightening of monetary policy in 2022. Also, we note that the Chinese new year celebrations could lead to a surge in COVID-19 cases in the country, given the low vaccination rate that could challenge the leadership commitment to re-opening. Finally, despite the energy crisis in Europe remains a challenge in two ways: Firstly, demand for energy could still pick up in the coming weeks as temperatures could drop or from rising China demand as the economy re-opens. Secondly, the re-fill season in the summer could be more challenging assuming China re-opens. We are therefore not out of the woods yet.

Going into 2023 we maintain a preference for European equity over their US counterparts, following many years of outperformance by the latter. We believe that Europe's lower valuation (currently the gap between EU and US is wide) implies that a lot of the bad news is already included in the price (Exhibit 16). We also prefer the sector mix in Europe, which is more favourable during periods of high inflation and rates, in our opinion. Also, we view the China re-opening as more supportive to European equity compared to other regions. On stock selection, we would recommend companies that focus on shareholders returns (high and safe dividend payers), have a strong balance sheet, as corporations will have to absorb the full impact from the higher financing costs (higher rates), companies that generate high and stable margins (as it will be more difficult to pass on higher costs during periods of economic weakness), companies exposed to China's re-opening and finally, companies that facilitate energy efficiency.

Exhibit 17 – Valuations – Developed markets

Valuations have come down significantly since the start of the year

Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	16.4x	11.8x	11.3x	10.9x	11.0x	9.7x	11.0x
Forward PE ratio (31/12/2021)	21.1x	15.7x	15.3x	13.2x	14.6x	12.1x	14.8x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	11.8x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	08/01/2013	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	15.9x	13.7x	12.7x	12.1x	13.3x	12.8x	13.7x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.3x
5th percentile	13.4x	11.3x	10.5x	10.4x	10.5x	9.9x	11.0x
Historical rank (since 2006)							
Percentile	78.8%	35.0%	37.3%	34.9%	31.2%	18.2%	29.1%
Current FPE, % above/ (below) 10-YR median	3.2%	-13.7%	-11.4%	-9.6%	-17.2%	-24.2%	-19.7%
Current FPE, % above/ (below) Dec 21	-22.0%	-24.9%	-26.3%	-17.1%	-24.4%	-20.2%	-25.6%

Source: Bloomberg

Key – Our view

Positive | Positive/ neutral | Neutral | Neutral/ negative | Negative

Key – Allocation

Overweight | Neutral | Underweight

Asset Class	Positioning
Developed Market Sovereign Bonds	We remain cautious on Government bonds given inflationary pressures on central banks' commitment to fight inflation. More recent readings have been encouraging in this respect, though central bankers have reiterated that far more evidence is required before we can begin to see an end to the current hiking cycle. Given the rising probability of recession, 2-year US Treasury paper, as close to a risk free investment as you can get, yielding in excess of 4% is seen as a suitable alternative to risky assets.
Investment Grade Corporate Bonds	Investment grade returns will continue to depend on movements in benchmark rates and corporate spreads, though following the material widening since the onset of the Ukraine conflict, the asset class has begun providing reasonable opportunities to add risk on a selective basis. At current levels, the asset class offers a significantly better cushion against adverse movements in benchmark bond yields than we have seen for a number of years. The default and rating environment for global credit continues to show signs of weakening, reinforcing our preference to move further up in credit quality where possible. Whilst we acknowledge the risks for benchmark rates to move higher, we prefer to increase our exposure to IG corporate bonds. Given the growing narrative around peak inflation, we are marginally more comfortable with moderating our short duration stance and extending further out the curve to be closer to neutral vs the benchmark.
High Yield Corporate Bonds	The elevated uncertainty on the growth outlook and higher inflationary forces as a result of the war in Ukraine has led to a substantial widening in credit spreads. We continue to like the asset class at current valuations, though as we begin to see signs of weakness in the outlook for global credit quality, we move to a neutral allocation relative to the benchmark exposure. The focus nevertheless remains on identifying positions on a name-by-name basis, screening for issuers based on resilience of cash flow and strength of balance sheets that should see limited drag on operational performance as finance costs and input costs increase in the face of slowing growth. We place additional focus on names and sectors less exposed to a potential economic slowdown and on issuers at the upper end of the HY rating scale to avoid downgrades into distressed territory.
Developed Market Equities	We expect the narrative to shift away from rates anxiety to economic strength during 2023. Although we acknowledge the positive news flow so far in 2023 (mainly the warmer than expected weather in Europe, the labour market resilience in the US and the commitment of China's leadership to re-open the economy), we still expect heightened volatility in 1H23. Temperatures in Europe could fall over the coming weeks, whilst cases in China may surge following the new year celebrations leading to renewed lockdown measures. Also, the lagged impact from the aggressive tightening cycle is yet to be fully felt. Currently cyclical equity performance would be consistent with a PMI in the mid-50s, which implies a significant recovery in economic activity from current levels. Therefore, we continue to maintain an underweight position in developed market equities for the short term.
Emerging Market Equities	In our opinion Emerging market equities performance could be boosted if China re-opens its economy at a faster rate than expected. China has underperformed for the last two years, on the back of higher political risk and a slowing economy that was impacted by lockdowns and a weakening property market. The leadership seems to be committed to growth, announcing plans to re-open the economy over the coming weeks and to support the housing market. In our opinion, Emerging market equities could outperform given the high allocation to China at index level.

Disclaimer

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