December 2022

Global Equities - Market Outlook 2023

The key driver for global equities going into 2023 will be the trajectory of earnings and whether the US and the world goes into an earnings recession. Will the US Fed's rate hikes tip the US into a recession? We share our perspective on this question and why despite the uncertain macro outlook, we are excited about the opportunities beginning to surface, presenting great opportunities for active stock picking.

This information has been prepared by Northcape Capital, the underlying investment manager of the Warakirri Ethical Global Equities Fund.

Recap on key themes of 2022

During the pandemic, central banks across the world spent more than $11tn (over $5tn in the US alone) in response to the COVID-19 pandemic by purchasing securities increasing the money supply (quantitative easing) and lowering interest rates in an effort to greatly increase liquidity in the financial system and encourage lending and investment. What ensued during 2020 and 2021 was one of the biggest and quickest financial asset bubbles in history (Crypto, NFTs, SPACs, IPOs, non-profitable high growth tech stocks, etc).

It is no surprise that inflation and interest rates have been the two key drivers of global equity markets in 2022 unprecedented amount of stimulus (both fiscal and monetary) injected into the global economy.

US Fed's stunning policy reversal drives de-rating of all asset values

This was the year when the Fed finally admitted that the highest inflation rate since the early 1980s was not "transitory" in a stunning mea culpa. US CPI peaked in June this year at +9.1% YoY and has been growing above 7% p.a. each month since. In response, the Fed (and other global Central Banks) set about rapidly raising the Federal Funds Rate from 0% to 3.75% thus far, with another 0.5% increase expected in mid-December.

In addition, the Fed has shifted from Quantitative Easing (QE) to Quantitative Tightening (QT) monetary policy, to shrink the central bank's monetary reserves and reduce financial market liquidity. This extreme policy reversal from abundant global liquidity and low/zero interest rates resulted in a de-rating of all asset values. Equities were no exception and at one point during the year the MSCI World was down 25% in USD as MSCI World forward PE valuation multiples de-rated from 19.4x to 13.7x.

As one would expect, longer duration and higher growth stocks de-rated more than the slow or no-growth value stocks.

Exhibit 1: Growth has underperformed Value during the valuation de-rating this year

MSCI World Index (white), MSCI World Growth Index (orange), MSCI World Value Index (yellow).

Source: Bloomberg

Looming US recession threatens earnings

Looking forward into 2023, we think the key driver for global equities will be the trajectory of earnings and whether the US and the world goes into an earnings recession. Central banks have been raising interest rates to put the brakes on economic activity to help reduce demand and cool inflation.

The key question is whether these actions will end up putting the economy into recession, which is typically the outcome of most rate hiking cycles. This is especially true when CPI is >4.5%: in this scenario a soft landing (i.e. a cooling of inflation without putting the economy into recession) has never been achieved. To achieve a soft landing would be the equivalent of central banks "threading the needle" with everything going right. While this is possible, we don't think it is probable.

We believe 2023 should see inflation continue to cool, and consequently see the Fed Funds Rate reach its peak and then enter a period of stability while the Fed waits for the lagged impacts of higher rates to flow through to the real economy. We could even see rate cuts if a recession eventuates next year.

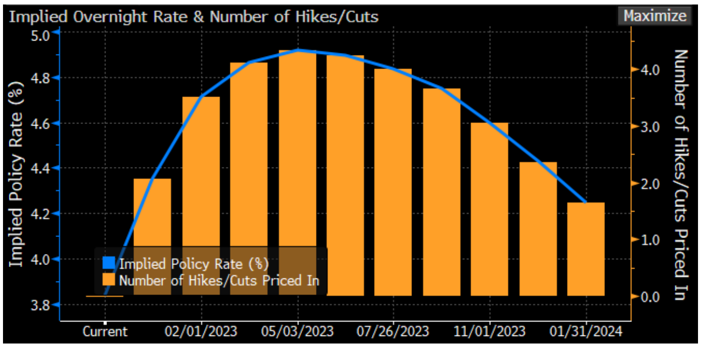
What path will the Fed take in 2023?

We are likely in the latter innings of the Fed's interest rate hiking cycle after the quickest hiking cycle in recent history and based on Powell's recent speech, he indicated a potentially slower pace of interest rate hikes from December onwards (read 0.5% hike not 0.75%), amid uncertainty in the economic outlook but holding rates higher for a longer period.

He also highlighted that the "terminal rate" (peak Fed Funds rate of the cycle), is likely to be "somewhat higher" than the 4.6% indicated by the FOMC's September projections (likely 4.75-5% we think). Currently the market is pricing in a peak in the Fed Funds rate around 5% in May 2023 followed by interest rate cuts of 0.5% by the end of 2023 (**see Exhibit 2**).

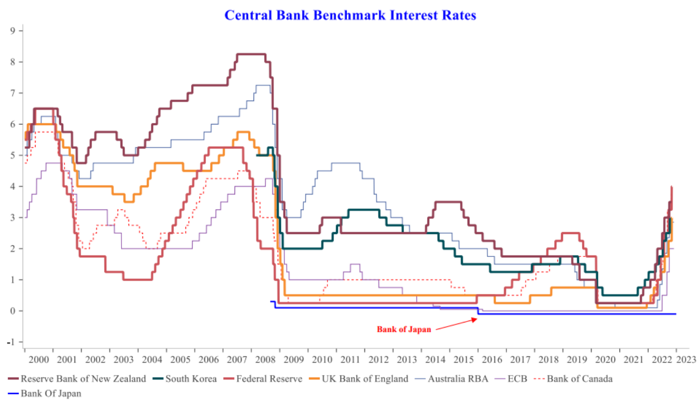
Whether there will be any rate cuts in 2023 we think will be largely dependent on whether a recession occurs and the path of inflation. If there is a recession, then steep rate cuts are highly likely or in a soft-landing scenario, more gradual rate cuts.

Exhibit 2: Market Implied Fed Funds rate forecast



Source: Bloomberg

Exhibit 3: Global Race for Central Banks to combat high inflation pulse (with exception of Japan)



Source: Strategas/Macrobond

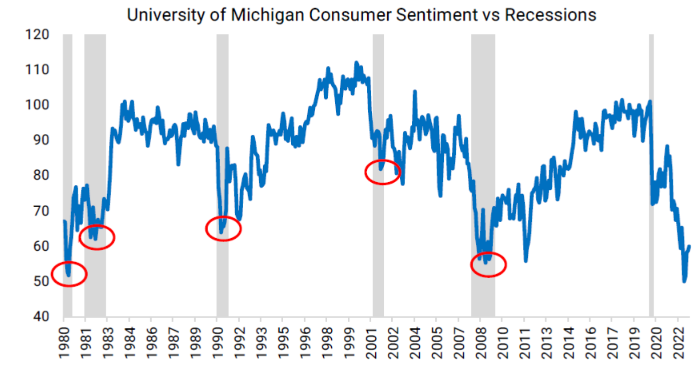
Europe worse placed than the US

We are bottom-up stock investors, and the team has a variety of views given our multi-portfolio manager approach. That said, we do look at several forward-looking economic indicators and bond market yield curves to give us a clue as to the outlook for a global recession in 2023/24. Our on-the-ground view from company meetings this year in the US and Europe is that Europe is worse placed than the US and is likely leading the US by around 6 months in terms of where it is in the economic cycle. On top of high inflation, Europe is also dealing with an energy shortage crisis and high energy prices.

In the US, the two main scenarios are either a soft or a typical recession. Usually, the Fed can begin cutting rates at the first sign of economic weakness. However, with high inflation levels, the Fed has competing priorities between supporting the economy or letting inflation continue unhinged.

Supporting a soft landing this time is the tight US labour market where there are nearly two job openings for every unemployed person, along with some excess savings left over from the pandemic fiscal stimulus. Powell mentioned in his recent speech: "I do continue to believe that there is a path to a soft, or a soft-ish landing" which is defined as a slight rise in unemployment without a severe recession.

Exhibit 4: US Consumer Sentiment currently at levels typical of recessions in the past.



Source: Bloomberg, Morgan Stanley Research

Where will the growth be in 2023?

There is a clear trend towards de-globalisation with reshoring/onshoring/friend-shoring and the associated supply chain realignments. We think the coming years should see the globalisation trend of recent decades reverse. This bodes well for certain parts of the industrial sector as the companies that "make things". We are hearing more companies opening manufacturing plants in the US from EV factories, semiconductor chip fabs and other manufacturers such as Techtronic in our portfolio.

Adding to these reshoring activities is the $550bn US Infrastructure stimulus bill and the Inflation Reduction Act with $440bn flagged for renewable energy which further adds to corporate capex plans.

Healthcare is another sector well positioned for growth in the year ahead in what is likely a slowing economic growth environment. Some areas were COVID beneficiaries, especially related to COVID testing, while others were more impacted like elective surgery. These trends have been normalising in 2022 and looking ahead the sector overall should continue to grow given the essential nature of the sector.

Consumer Staples should continue to grow during an economic slowdown given its defensive characteristics as consumers continue to buy staples. The sector has had a degree of pricing power, passing through inflationary cost pressures. As commodity prices have eased in recent months, this should become a tailwind to gross margins which have been negatively impacted as commodity prices were rapidly increasing.

On the contrary, we think Consumer Discretionary will be a challenged sector, especially on the goods side with demand trends normalising from the overconsumption that occurred during recent years due to COVID. Consumer sentiment is weak and there is likely an excess of inventories which need to be discounted which will hurt margins. Consumers shifting their spend away from discretionary items (especially goods) is something we are hearing retailers report as high inflation and negative real wage growth is negatively impacting household budgets.

Similarly Technology is likely also a challenged sector with hardware for example also suffering demand hangover from a demand pull forward during COVID and work from home. On the software side we are starting to see the early stages of demand weakening as contract durations are getting shortened, deals taking longer to get approved and sales requiring approval from higher ranking management etc.

In Conclusion: Looking ahead

In the current late cycle environment, we believe our portfolio is well placed to navigate a more challenging macro-economic environment given the quality and earnings resilience of the businesses in which we look to invest.

We are comfortable with our current defensive positioning ahead of an increasingly likely earnings recession scenario with our portfolio having a high degree of relative earnings certainty. Should an economic recession be avoided, and the Fed is successful in slowing inflation without the need for higher rates for longer, the strategy should also be well placed to benefit. Our high-quality portfolio with longer duration secular growth stocks tend to outperform in this scenario, as we saw in November.

We are excited about the opportunities beginning to surface with many of the high-quality businesses on our wish list looking more attractively valued. Turning points in the cycle present great opportunities for active stock picking.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au