GLOBAL MARKETS

4TH QUARTER 2022
MARKET OVERVIEW

BOWMORE
ASSET MANAGEMENT

FOR RETAIL CLIENTS

FEBRUARY 2023

Contents

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Welcome

The Sun Finally Peaks Through The Clouds

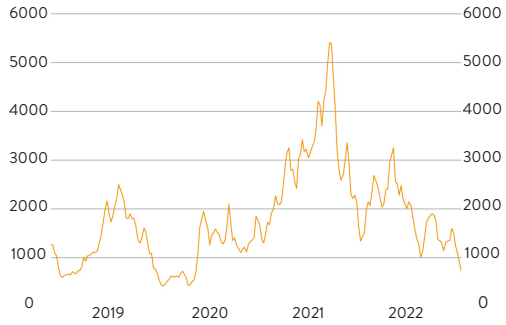
While the storm clouds of inflation and the war in Ukraine loomed over markets during the summer, the outlook, ironically, brightened in the autumn and winter as chinks of light began to shine on the global economy. Signs that inflation may have peaked in major economies allowed investors to believe that the end of the interest-rate-hiking cycle could be in sight in 2023.

And while central bankers around the world continued to increase interest rates at a pace and scale not seen for decades, investors' new-found hope was encouraged by the Federal Reserve, which adopted a less hawkish stance in terms of language[1]. Officials indicated that they were considering whether to reduce the pace of monetary tightening as the economy slows.

Moreover, in December the central bank backed this view by raising the overnight borrowing rate by just 0.5%, taking it to a range of between 4.25% and 4.5%, following four straight 0.75% moves. December's move meant that interest rates are now at their highest level in 15 years.

Official data certainly supported optimism that inflationary pressures are easing in many markets as supply chains – gridlocked by pandemic lockdowns and further disrupted by the Ukraine war – gradually loosen up. In November, for example, the US consumer price index rose by just 0.1% from the previous month and increased at an annual pace of 7.1%, down from a 2022 peak of 9% in June[2].

A similar story could be seen across the Atlantic, with inflation in the eurozone ebbing to an annual 10.1% in November 2022, from 10.6% in October[3]. Evidence that inflation's grip on the global economy is loosening can also be seen elsewhere. The cost of shipping a container across the oceans – the highway for more than 80% of the world's goods trade – increased seven-fold in the 18 months from March 2020. As the chart to the right shows, however, prices plummeted in 2022. This should have a significant impact on the final cost of goods to consumers.



Baltic dry index chart
Source: Refintiv Datastream

Optimism that the global economy will avoid a severe downturn in 2023 naturally accompanied the belief that the worst is over as far as inflation is concerned. Nowhere is this more apparent than in Germany, the eurozone's largest economy, where fears that the successful economic model of manufacturing exports fuelled by cheap Russian energy appeared on the brink of collapse back in the summer. Following a mild winter and plunging gas prices, however, many analysts now believe that Germany can avoid a recession entirely in 2023.

1 Wall Street Journal
2 CNBC
3 Eurostat

China's decision to ease its severe COVID-19 restrictions, which have hobbled activity in the world's second-largest economy for three years, also fired optimism about the economy's prospects in 2023. The relaxation of China's strict controls on movement, etc., followed widespread protests in the country. The impact of those controls on economic growth are clear from official data, which shows that China's economy grew at the second slowest pace in almost half a century in 2022[4].

Many analysts now believe that China's reopening could significantly boost global growth in 2023, given the level of pent-up demand. It could help offset slow or even negative growth in the advanced Western economies, where consumers continue to struggle with high borrowing costs and prices – although these pressures should ease as the year progresses.

Turning to developments in global markets in the final quarter of 2022, hopes that an end to the aggressive cycle of interest-rate hikes could be in sight – driven by positive news on inflation – powered stocks higher in October and November. However, stocks fell back in December as investors digested relatively strong economic data out of the US – data that could give the Federal Reserve pause for thought as it considers its next moves in monetary policy[5]. Overall, the year saw a sharp reversal for equities, which delivered their worst annual performance since the dark days of the global financial crisis.

Global equities rose by 9.42% in US dollar terms over the quarter but fell by 19.46% over the year. Value stocks (where the share price appears to be less than the company is actually worth, according to various metrics) were once again to the fore, significantly outperforming growth stocks (companies where revenues and profits are expected to increase faster than the average for the overall market) over the quarter.

In geographic terms, European markets were among the strongest performers, gaining 10.77% in local terms, supported by upwards revisions in earnings estimates and signs that the economic outlook might not be as bad as was earlier feared.

Rising interest rates always prove a challenge for fixed-income investors, and this again proved the case over the quarter and, more particularly, the year. The yield on the benchmark 10-year US Treasury ended the year at 3.88% – significantly higher than the 1.5% seen at the end of 2021[6].

4 Goldmansachs
5 CNN Business
6 CNBC

Yields move inversely to prices, so the fact that the rise in yields was the greatest since the 1960s was bad news for bond investors. Moreover, borrowing costs for mortgages and other loans are linked to Treasury yields. However, the quarter saw hopes of better days ahead: the 10-year Treasury yield rose only slightly over the last 3 months of the year (the yield ended September at 3.88%).

Prices for UK corporate bonds rallied strongly as investors grew more optimistic about the outlook for the economy, with bonds issued by financial services businesses – whose fortunes are closely tied to those of the overall economy – among the best performers.

US and eurozone corporate bonds also fared well, outperforming government bonds over the quarter. Both investment-grade bonds (issued by companies with a strong financial profile) and high-yield bonds (issued by businesses that are more likely to default on their debt than those of investment grade) delivered positive returns.

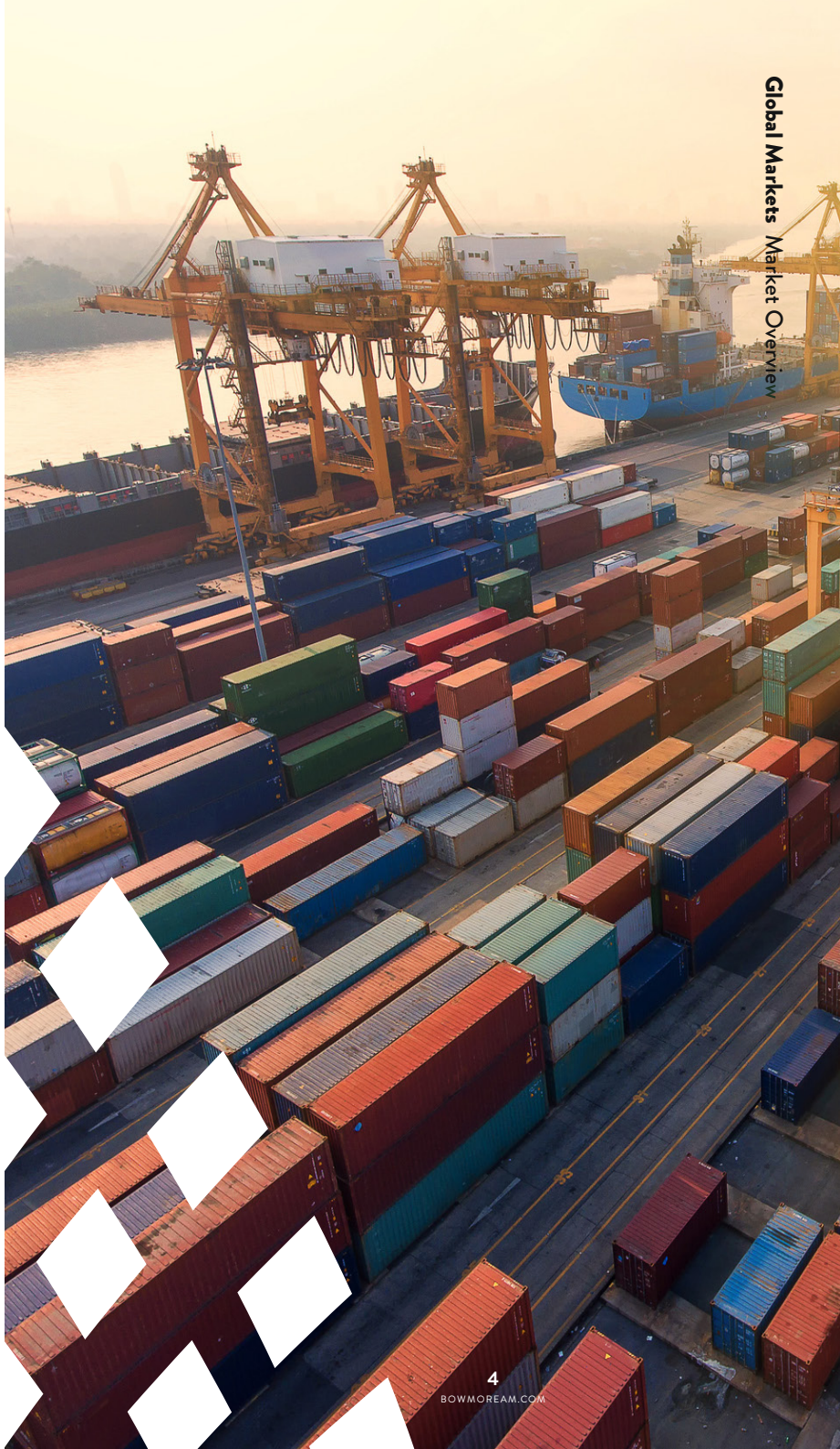
Meanwhile, the Japanese central bank caught investors off guard in December, unexpectedly loosening a control on bond yields – interpreted by some investors as a sign that it will pivot towards tightening monetary policy[7]. This caused a sell-off in fixed income globally towards the end of the year.

US 10-year Treasury yield over 2022
Source: Refintiv Datastream

Japan has spent decades battling deflation – a situation in which prices fall persistently across the economy – because the phenomenon can prove very dangerous. That's because consumers and businesses delay spending in the belief that a purchase could be even cheaper in the future. That can result in a downward economic spiral that is difficult to reverse.

The Central Bank has maintained an ultra-loose monetary policy for many years in an effort to stimulate inflation, without success. However, there are now signs that inflation is gaining traction in Japan: consumer price inflation edged up to 3.7% in November, the highest level in 41 years[7].

7 Reuters



UK Equities

The Calm After The Storm

Despite a turbulent start to the quarter, which saw the country's second prime minister of the year, Liz Truss, replaced by its third, Rishi Sunak, and the reversal of almost all the measures announced in September's mini-budget, UK equities outperformed other major markets, such as the US and Japan, delivering a 7.95% rise over the quarter.

The UK was also the only major market to deliver positive returns in 2022, aided by its focus on energy and mining companies and pharmaceutical stocks. The former benefitted from the strength of commodity prices, sterling weakness (commodities tend to be priced in dollars) and strong overseas earnings, while the latter are benefitting from hikes in healthcare spending following the COVID-19 pandemic.

Small caps outperformed large caps as investors became less risk averse over the quarter, while value stocks continued to outperform the growth sector[9].

Our Stance

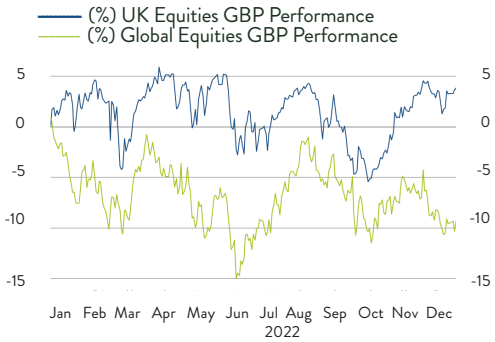
Our stance on global markets remains neutral. As recessionary pressures build, central banks are softening their previous hard-line stance on tightening monetary policy. However, further hikes in interest rates can be expected, given still-elevated levels of inflation. With the economic growth outlook remaining uncertain, the prospects for equities also appear opaque in the medium term at least. However, we can see value emerging in markets as the year progresses.

NEGATIVE NEUTRAL POSITIVE

8 Telegraph
9 Yahoo! Finance

In December, the Bank of England (BoE) increased interest rates by 0.5%, to 3.5– the ninth hike since December 2021[10]. Consumer price inflation reached its highest level since 1981 in October, at 11.1%, before dropping to 10.7% in November. The BoE expects inflation to remain elevated over the coming months, but to fall to about 5% by late 2023.

Sunak re-appointed Jeremy Hunt as Chancellor, who in November unveiled a £55bn package of tax rises and spending cuts to stabilise Britain's public finances after a series of economic shocks[11]. The tax burden has risen to its highest level since World War II, and rising energy costs are also weighing on household budgets. The economy performed worse than expected in the three months to September, shrinking by 0.3%, compared with an earlier estimate of 0.2%[11]. Household spending fell for the first time since the final COVID-19 lockdown in the spring of 2021.



UK equities versus global over 2022
Source: Refintiv Datastream

Sterling's rollercoaster ride

Following chancellor Kwasi Kwarteng's pro-growth mini-budget in late September, the pound fell to an all-time low, trading at US$1.0327, its lowest level since the UK adopted decimal coinage in 1971[12]. That weakness continued into October, with many forecasters arguing that sterling would hit parity with the dollar.

The popular narrative is that Hunt's November package saved the pound from that ignominy – sterling rallied to end the year at 1.21. The revisions to the mini-budget certainly helped to restore confidence in the UK, but the greenback also weakened against many other currencies in December as investors revised down their forecasts for US rate hikes.

Sterling against the Dollar
Source: Refintiv Datastream

Our Stance

We anticipate that the UK will experience weaker economic activity than the global economy in general. However, we believe opportunities among small and mid-cap companies will emerge due to their higher exposures to domestic demand across sectors. UK small and mid-cap equities had a tough year in 2022 but is now piquing interest of investors due to their attractive prices. We consider the UK a not easy place to be as the economy is not showing positive signs for 2023, however company valuations generally lower across the UK market. Historically, small and mid cap overperformed after such negative period as optimism returns to the general equity market .

NEGATIVE NEUTRAL POSITIVE

10 Reuters
11 Investment Week
12 Financial Times

US Equities

Light at The End of The Interest-Rate Tunnel

Investors continued to focus on the Federal Reserve's language as well as its actions over the quarter, as they tried to assess how much higher interest rates will go. Inflation is, of course, another important pointer to the direction of monetary policy. The string of quarterly declines in US stocks came to a halt in the fourth quarter as the market registered its first quarterly gain in 2022, supported by hopes that inflationary pressures are finally ebbing.

However, high-flying technology stocks once again performed poorly, with the likes of Amazon and Google sharply down: Amazon fell as low as US$81.82, having started the quarter at US$113, while Google dipped to a nadir of US$83.41, from US$96.65 at the end of September. Tesla was among the worst performers as concerns over demand and supply issues threatened the electric-vehicle maker[13].

Stocks rallied in October and November amid better news on inflation, which slowed to an annual pace of 7.1% in November, from 7.7% in October[14]. However, news that US economic growth had been unexpectedly revised upwards to an annual pace of 3.2% in November (from 2.9%), and that jobless claims were lower than expected, prompted investors to reassess their views on how quickly inflation might fall, and stocks fell back in December[15].

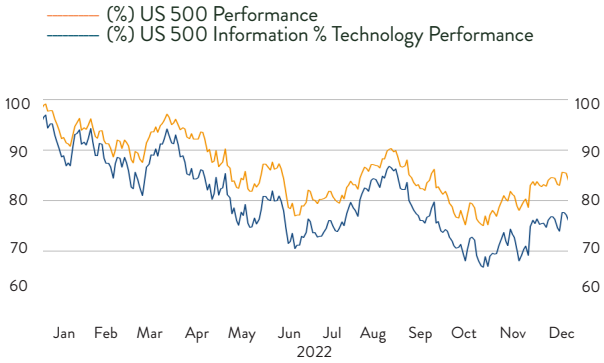
As ever in economics, nothing is simple and inflation doves could take succour from figures showing the prices paid by factories for inputs fell for a second straight month in November, supporting views that inflation is trending lower. A forward-looking indicator, for new manufacturing orders, also remained negative for the third consecutive month in November another pointer suggesting economic weakness lies ahead.

Overall, there is little doubt that markets believe that inflation has peaked and that the end of the rate-hiking cycle is in sight – so discounting the Fed's language about pushing rates higher than 5%[16].

Our Stance

We are cautiously positive about US equities in the short term, while hedging some of the currency risk priced in by a strong dollar. The US economy appears robust, and monetary policy will remain centre stage as markets seek to assess how much further interest rates will rise. We believe that the US market – and particularly certain sectors that have suffered sharp reversals this year – will rally strongly when the global outlook improves.

NEGATIVE NEUTRAL POSITIVE



US equities overall versus technology stocks over 2022 Source: Refintiv Datastream

13 Bloomberg
14 BBC
15 Mint
16 CNN Business

European Equities

Fears of the Energy Fallout From The Ukraine War Ease

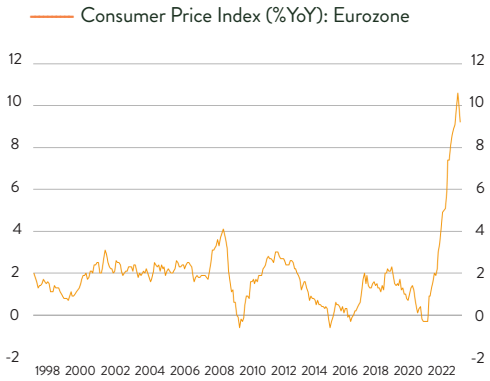
For the year as a whole, European equities lost 14.88% – their worst annual performance since 2018. Value stocks (such as financials, which benefit from higher interest rates) outperformed, while growth stocks lagged the index. Rising borrowing costs often hurt companies in the latter sector, which tend to borrow heavily to finance their expansion.

Concern over energy shortages and possible blackouts in the winter – caused by Russian supply cuts – eased as the quarter developed. Gas storage ended the year at very healthy levels – rising from around 26% of capacity in March to over 80% by the year end – with energy costs falling sharply from the highs seen earlier in the year, following Russia's invasion of Ukraine[17]. By the end of the year, the price of natural gas in the EU had declined to €55.28, from a high of €339.05 on 26th August[18].

Upwards revisions to earnings provided support, reflecting the ability of many European companies to withstand the adverse economic environment. For example, companies that derive a large chunk of their profits from exports have benefited from the weakness of the euro, while commodity businesses have gained from high prices for raw materials.

The ECB slowed its rate-rising cycle, upping borrowing costs by a further 0.5% in December, to 2% – following record 0.75% hikes in July and October– but warned that further hikes were on the way as it strives to return inflation to its 2% target[19].

Hopes that inflation may be peaking provided further support. Annual inflation fell to 10.1% in the eurozone in November down from 10.6% in October[20]. Meanwhile economic growth slowed to 0.3% in the eurozone in the third quarter, from 0.8% in the second three months of the year[21].



Eurozone Consumer Price Index
Source: Refintiv Datastream

17 European Council
18 Trading Economics
19 AP News

20 European Central Bank
21 Eurostat

Our Stance

Our continued negative view on Europe reflects the region's proximity to Russia and its continued reliance on Russian energy, particularly given the ongoing war in Ukraine. Russia supplied 40% of the EU's natural-gas imports in 2021, and although the region has dramatically cut its dependence on Russian energy – European imports of Russian gas fell by 55% in 2022 – that has increased energy costs for Europe as the Continent scrambles to develop new sources of energy and build stockpiles. We reduced our exposure to Europe in the third quarter, in favour of short-term cash. However, we retain positions in stocks chosen by active managers, which performed strongly in 2022.

Japan

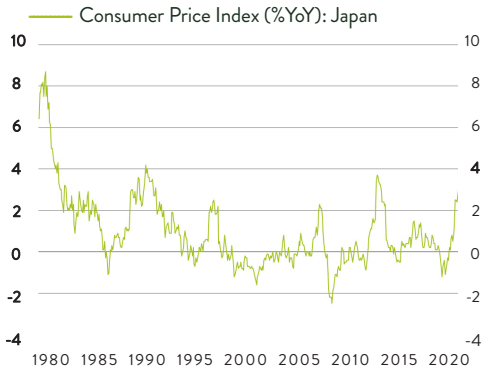
The Comeback Kid Finally Makes a Comeback

Japanese stocks have been tipped to outperform many times in recent decades: at the end of 2022, the Nikkei 225 Index of Japanese equities stood at 26,406, still well below the peak of 38,512 reached in 1990[22]. That message is now being repeated again on signs that Japan's decades-long battle against deflation is finally being won, as well as on hopes that economic reforms are bearing fruit.

Certainly, Japanese stocks fared much better than other major markets over the year, losing 5.05%, compared with a 19.46% decline in global equities. In the final quarter, however, they rose by a relatively modest amount compared with the increases in other developed markets, gaining 3.04%.

Strong quarterly earnings and share buybacks helped drive equities higher in October and November[23]. However, the central bank's decision to loosen its control on bond yields – interpreted by some investors as a sign that the central bank will pivot towards tightening monetary policy – contributed to the decline in equity prices in December.

The move also prompted the yen to jump to a four-month high against the US dollar. Meanwhile, headline consumer price inflation marked its highest level in 30 years, reaching an annual pace of 3.8% at the end of November[24].



Japanese inflation since 1980

Source: Refintiv Datastream

Our Stance

Our positive view on Japan reflects the loose monetary stance adopted by the central bank amid steadily rising inflation. The central bank's pivot on monetary policy in December provides support for the yen. A stronger currency could handicap exporters but should prove beneficial to the economy overall by cutting the trade deficit, which reached a record high of ¥19.97 trillion (US$155.27 billion) in 2022, as higher energy and raw-material prices – along with the yen's sharp fall – boosted import costs. Meanwhile, Japan benefits from diverse sources of energy – unlike some other advanced economies.

NEGATIVE NEUTRAL POSITIVE

22 Kyodo News
23 Xinhua
24 Daily FX

Asia + Emerging Markets

The emerging bear awakens

Could the long bear market in emerging economies finally be coming to an end? The downturn began in 2010 and intensified over much of 2022 on the back of a strong dollar, traditionally a negative for the asset class[25].

However, while the sector underperformed advanced markets such as the US and Europe in the fourth quarter of 2022, it significantly outperformed Japan. It seems there are finally grounds for optimism among emerging-market bulls. These include the weakening dollar and the easing of COVID-19 restrictions in China. The latter provided a fillip to Far East stocks in particular in the final quarter.

Latin American stocks, which are heavily weighted towards commodities, performed relatively poorly as slowing global growth weighed on commodity prices[26]. But that could all change in 2023, too, given that commodity prices have surged recently on the back of an expected pick-up in demand in China, which pre-COVID had a seemingly insatiable demand for the region's raw materials.

25 Rueters
26 Project Syndicate

Brazilian stocks fell over the period, reflecting uncertainty over the economic policies to be pursued by President Lula, who defeated the controversial incumbent Jair Bolsonaro in the 2nd October general election. Lula previously served as the country's leader from 2003 to 2010, a period marked by numerous corruption scandals. In 2017, Lula was sentenced to prison after being convicted of money laundering and other crimes. He was freed early from jail in 2019 due to concerns over the court case.

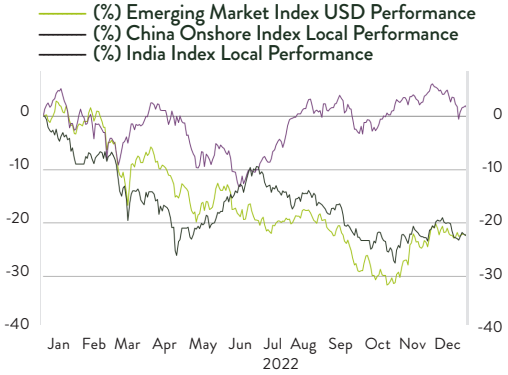
Turkish stocks were a standout performer, rising by 64.18% in local terms over the quarter as investors sought refuge from the ravages of soaring inflation[27]. However with such unpredictability and forex volatility we tend to be very careful with such holdings. Indian equities also surged upwards, reaching a record high in December, buoyed by increasing optimism about the country's economic prospects. We feel like India is in a similar position to that of China at the beginning of the century with an expected growth in 2023 above 5.5%.

Economic reforms and signs that many of the companies moving out of China are relocating to India helped fuel demand for Indian stocks. However, they gave up some of the gains in the final weeks of trading partly due to profit-taking. and concerns about the earnings outlook.

China performed strongly over the quarter, gaining 12.32% on hopes that economic growth will accelerate as economic activity normalises.

India gained just 3.53% but strongly outperformed China over the year, gaining 1.57%, compared with China's decline of 22.41%.

Egyptian stocks were another strong performer, rising by 60.73% in the quarter, helped by an IMF deal[28]. COVID-19 and the Ukraine war had earlier hit the already struggling Egyptian economy, hobbled by fast-rising debt to finance a government spending spree. As part of the US$3bn bailout, the authorities have pledged to reduce the role of the military in the economy[29].



Chinese, Indian and EM equities 2022

Source: Refintiv Datastream

27 Financial Times
28 International Monetary Fund
29 Business Recorder

Our Stance

The weakening of the US dollar and the oil price, traditionally positive trends for Asia and emerging markets, should support the region. The opening of the Chinese economy following the relaxation of COVID-19 controls should add further support, while the Chinese economy should benefit from loose monetary policies given the absence of inflation. Asian and emerging markets have been less affected than regions such as Europe by the hike in energy prices that took place in 2022. Indeed, the likes of India and China have been able to demand steep discounts on Russian energy because they know Moscow has limited export options due to the Western sanctions imposed following the invasion of Ukraine.

Fixed Interest

Government Bonds

Italian Borrowing Costs a Focus of Concern In 2023

Government bond yields continued to move up over the quarter as central banks maintained their fight against inflation with further interest-rate hikes. Prices fell because higher interest rates undermine the appeal of the fixed income generated by these instruments. The 10-year German bund, which was in negative territory as recently as March, for example, ended the year at a 2022 high of 2.56%[30].

The spike in bund yields and the ECB's rate hikes are pressuring the bonds of southern European countries. The yield spread (the difference between the yields on two bonds from separate issuers) for German and Italian 10-year bonds – regarded as a major risk gauge in the region – rose significantly over the year.

Having eased in October and November, the spread widened sharply again in December after the ECB hiked rates and said it would begin quantitative tightening (QT) from March 2023[31]. QT will raise longer-term borrowing costs whereas rate hikes generally impact short-term funding costs.

While the yield on the 10-year US Treasury was barely changed over the quarter, rising from 3.81% to 3.88%, the intervening period witnessed sharp variations, with yields falling as low as 3.4% and moving to highs of 4.23% as markets sought to interpret conflicting data on inflation and the strength of the economy. The yield curve inverted – when short-term rates exceed those of longer-dated bonds – from November to the end of December[32]. This development has preceded a recession on every occasion since the late 1960s.

German 10-year bund yield 2022
Source: Refintiv Datastream

In contrast to other core government bonds, 10-year UK Gilt yields moved lower over the quarter, falling from 4.15% to 3.67%[33]. But this trend was largely explained by the spike in yields that took place during the ill-fated administration of Prime Minister Liz Truss, who stepped down in October. Along with other government bonds, Gilts moved higher after the Bank of Japan moved to loosen the cap on yields in December.

Our Stance

We have a neutral stance on government bonds despite the setbacks suffered over the past year. The asset class is now better placed to protect portfolios against falling equity markets, given the weakening of global growth and the threat of recession. Rising yields have also opened up areas of value across sovereign bond markets.

NEGATIVE NEUTRAL POSITIVE

30 Market Watch
31 Reuters
32 Bloomberg
33 Trading Economics

Credit and high yield

Good times for corporate bonds

Corporate bonds delivered positive returns over the quarter, and spreads with government bonds tightened. Corporate bonds delivered 9.4% over the three months, with high yield outperforming to deliver 10.86% in dollar terms[34]. Risk appetite improved as investors scaled back their expectations for the path of future interest rates[34]. Issuance also picked up strongly as financial conditions eased.

Our Stance

We have changed our stance from negative to neutral. Yields are now much more attractive and there are opportunities to benefit from higher coupons as new issues come to the market. Spreads in high yield have not widened as much as in investment grade, reflecting the potential for a recession – in which less financially robust companies are clearly the most exposed.

NEGATIVE NEUTRAL POSITIVE

Commodities

China Bulls Spread Optimism

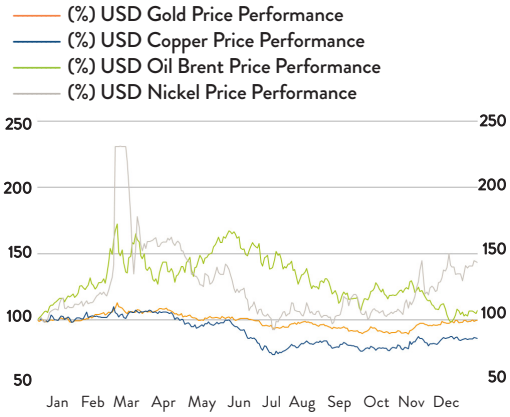
The broad commodity index gained just 1.18% in the fourth quarter, completing a strong year in which the index rose by 13.75%. Oil prices (Brent), which influence the price of many other commodities, declined by 4.7% over the quarter, to US$82.82, on the prospect of weakening global demand[35]. The price of industrial metals proved highly volatile over the quarter but overall rose sharply, by 15.26%, while precious metals gained 12.17%. China's reopening has seen the price of many commodities spike higher[34].

34 Financial Times
35 Macrotrends

Our Stance

Our view has shifted to neutral, from positive earlier in the year, as demand and pricing is expected to weaken. However, supply constraints could continue to support prices, especially if demand remains buoyant.

NEGATIVE NEUTRAL POSITIVE

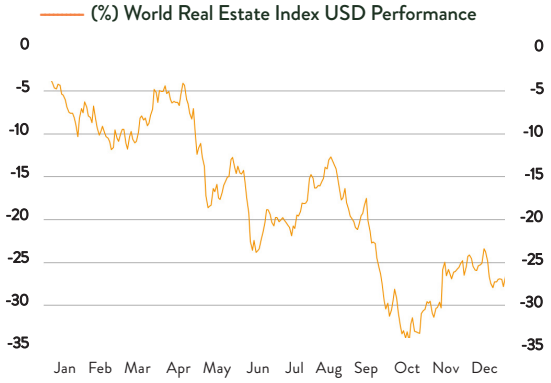


Nickel, copper and gold price over 2022
Source: Refintiv Datastream

Property

UK Housing Market Under Pressure

UK property prices came under pressure in the final quarter as mortgage rates spiked, rising from 5.1% in September to 6.41% in December[37]. Meanwhile, global real-estate funds recovered, with the global REIT index gaining 3.06% over the quarter as the market scaled back expectations for rate hikes in 2023. That being said, the index lost 27.46% over the year as the global property boom came to an abrupt end.



Global real estate 2022

Source: Refintiv Datastream

37 Trading Economics

Our Stance

We are less optimistic about the outlook for property, given the impact of higher interest rates on liquidity. Although there have already been setbacks within the sector, our focus on closed-ended and listed assets means that liquidity is less of an issue than might otherwise be the case. Strong relationships between managers and tenants also provide security.

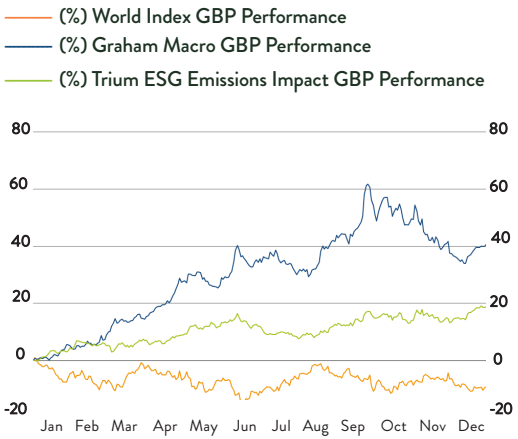
NEGATIVE NEUTRAL POSITIVE

Structured Products and Hedge Funds

Hedge Funds Shine in 2022

Structured products contributed positively to performance in the fourth quarter. As investment markets fall, and yields move higher, the opportunity for future allocation within this space becomes more compelling, with the market offering higher yields at more attractive levels.

Hedge funds delivered a positive performance over the quarter, providing a mildly positive return for portfolios. This was one of the few sectors to outperform throughout 2022. Within the sector, equity funds were the worst performers over the year as managers struggled amid high volatility[38]. Macro-driven strategies performed the best, led by commodities, quantitative and trend-following strategies.



Hedge funds versus global equities 2022
Source: Refintiv Datastream

38 Reuters

Our Stance

We hold a positive view on both structured products and hedge funds. The volatile nature of short-term markets has provided opportunities to exploit pricing within the structured-products sector. The sector also helps to shield investors from volatility in equity markets, due to inbuilt features such as capital protection (many products allow the underlying stock-market index to fall by 30–40% during the product's life before the investor's initial invested capital is at risk). The latter advantage is particularly attractive given that we expect this volatility to continue. In the hedge-fund sector, the normalisation of monetary policy and the return of other fundamental drivers of the economic and financial cycle should support performance. The diversification provided by hedge funds should also benefit investors in 2023.

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Past performance is not a guide to future performance.

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