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MARKET OUTLOOK
13 DECEMBER 2022

2023 UNDER BETTER AUSPICES

- We expect a mild recession in the US and a more significant one in Europe with a decline in corporate margins
- The deterioration in liquidity prompts us to seek protection as soon as its cost decreases
- Fixed income markets offer visibility in a context of gradual disinflation

The negative factors that impacted the markets in 2022 appear to be waning. Of course we will not extrapolate the signs of easing near the end of the year to the very tense geopolitical front. We nevertheless note a more constructive tone between the United States and China at the last G20 summit. Furthermore, the question of the opening of peace talks between Russia and Ukraine is now being spoken about by all parties. For the markets, **the main easing point was US inflation**, with the first signs of a deceleration seen in November, which triggered a sharp rise in equities and bonds.

DISINFLATION LIKE A MAGNET

While we do anticipate a disinflation trend over the next two years, we acknowledge that, for now, there is only temporary disinflation in the United States. The return to normal of production chains and drop in commodity prices (if it is not reversed soon) and freight prices argue for a likely reduction in inflation via goods prices over a few months. Additionally, the ongoing contraction in US housing prices points to a slowdown in rental prices starting in the second half of the year. The labour market, however, remains very tight and wages continue to grow at 5%, which is compatible with overall inflation of around 4%. Moreover, the current disinflation, primarily technical, will inject some purchasing power, which does not favour the scenario of a sharp recession or a marked slowdown in wages. In other words, **disinflation as perceived by the markets will not necessarily follow a straight line**. This is undoubtedly the underlying trend that we believe will give direction to the markets in 2023.

THE RECESSION QUESTION PUSHED BACK TO 2023

While growth fell in 2022 as a result of inflation, it is far from having been stamped out. As a result, the profits of listed companies have been much stronger than expected so far, particularly in Europe, which is remarkable given the environment. **We expect a mild recession in the US and a more significant one in Europe with a contraction in corporate margins.** In other words, we expect profits to decline in 2023.

LIQUIDITY: THE REAL BLACK SPOT

The quantitative tightening policy continues in the United States, amongst other countries, and is expected to begin soon in Europe. The impact of these policies on the markets is complex and difficult to understand. **Periods of shrinking liquidity have historically led to significant air pockets in the markets**, the latest example being the crash in the fourth quarter of 2018. We therefore cannot rule out the return of this type of phenomenon without warning.

It should be noted that, in addition to the liquidity linked to the central banks, there is also the question of market liquidity. It is very low. Flows therefore have more impact on market prices than before.

The deterioration in liquidity prompts us to seek protection as soon as its cost decreases, regardless of the overall scenario. Indeed, while the very poor liquidity situations do not necessarily imply a correction, no one can deny that **the context raises the probability of a possible but unpredictable shock**.

NEITHER PESSIMISM NOR ENTHUSIASM FOR EQUITIES OVERALL

What is the impact for the equity markets? On the one hand, next year's dreaded recession is the biggest fear shared by investors and harbours few surprise effects unlike previous recessions. For the equity markets, **disinflation will support valuation multiples** in the same way as inflation penalised them in 2022. On the other hand, historically we have never seen a recession without a negative impact on the equity markets. It is unlikely we would be able to count on the central banks to come to the rescue of the economy or financial markets in 2023, unlike previous recessions. The markets anticipate that the Fed will begin to cut its rates in the second half of the year, which we think is unlikely given the Fed's very strong message on the need to maintain high rates for many months and the level of inflation, which, although slowing, will remain far too high compared to central bank standards. Moreover, **the support of central banks in a recession is very important for investors** as it helps them anticipate the end of the crisis. Given this analysis and the liquidity issue, it is difficult to be particularly optimistic about the equity markets. It is equally difficult to be pessimistic: investors have little exposure to the asset class and are staying cautious, which means that any good news can lead to a sharp rise, especially with market liquidity being so low. Historically, the best entry points have been at the heart of the recession. We will probably have to remain patient before increasing exposures.

In a context of stabilisation of US policy and the likely normalisation of Chinese economic policy after a very difficult period that caused growth to plummet, **we believe that emerging equities, after a long period of underperformance, have the greatest potential for a rebound**. US equities, to a lesser extent, should perform well. The underperformance of the growth style, which is highly represented in the S&P 500, a result of the rise in US rates, has less reason to continue given that we are near the end of the US rate hike cycle. European equities, unlike US equities, were able to take advantage of the very sharp increase in interest rates in the United States via the appreciation of the dollar, which boosted the profits of these high export companies. The dollar should stabilise next year with the US key rates. Conversely, European equities should benefit from the gradual normalisation of the Chinese economy that we expect for 2023. They will remain sensitive to the energy crisis and developments in the conflict in Ukraine, on which we will not speculate, but with the intuition that the profile seems more symmetrical than a few weeks ago. **European equities, which retrospectively have held up much better than expected, despite the damage the region suffered in 2022, can once again be a positive surprise**, making the asset class essential in the portfolios. Thus, it is not so much the geographical allocation that we believe will make the difference, or even the style (between growth and value), but the search for profitable companies, that are not too leveraged and have a financial position that allows for acquisitions.
The **healthcare** theme should continue to outperform, as the attractively valued sector benefits from structural growth and is not sensitive to the ups and downs of the cycle. The **Big Data** revolution and the continued spread of its use across the various sectors of the economy continue to offer excellent opportunities. Lastly, in a context in which the work relationship is undergoing profound changes, we are convinced that companies will structurally increase their investments in **human capital**.

BONDS RATHER THAN EQUITIES

There are already yields on certain bond markets that are close to or exceed the normative assumption of long-term equity market performance (around 7% per year). The implied volatility of government bonds is historically high, while that of the equity markets is not, as it is understood that we are close to a recession. All of this is **a sign of investors' high distrust of the bond markets**, which is not a surprise after the past year. **This nevertheless represents an opportunity.**

Without a doubt, our confidence in the disinflation trend leads to greater visibility on the potential of the bond market, especially as yields have recovered. In addition to the carry, at a multi-year high, the risk of capital loss seems much more limited on intermediate and longer maturities. We take the example of the US bond market, where monetary policy is

already in restrictive territory. **If inflation were to rise even further, the markets would anticipate more rate tightening and therefore also greater chances of a recession severe enough to break inflation.** Short-term rates would therefore rise, but less and less as maturities extend to the point that very long-term rates could even fall. Things are much more obvious in the United States than in Europe, which does not yet have a restrictive monetary policy and is also less readable. However, given the impact of the US bond market on the rest of the world, we are tempted to extrapolate this logic.

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