Insights: The year ahead
Jan 2023

The year ahead.

When we invest, our key focus is on themes that will shape market outcomes over the medium-term. But we know that that market consensus can get caught up in short-term topics. These topics can tend to drag market movements away from the economic fundamentals. These moves can sometimes be material.

In 2022, we observed two key topics that moved markets. These included a consensus view that;

a) The US would enter recession in early 2023, and
b) China is uninvestable.

Markets moved to reflect this consensus by pushing government bond yields materially higher and equity markets materially lower, and by punishing Chinese and Asian equity markets.
We disagreed with these consensus views through 2022. But we took steps to mitigate the impact of our contrarian views on our portfolios. As we progressed through 2022, we became more comfortable with our views. Importantly, markets moved much closer to reflect our view of the world in Q4 2022.

As we enter 2023, we think it is useful to set out our view on the two key topics that we think will shape 2023. These topics are:

a) The Fed will probably not cause a recession this year, and
b) China is not uninvestable.

It is important for us to point out that we are not short-term investors. We are not forecasting near-term outcomes. But being aware of the risks and opportunities over the coming 12 months will help us, and other investors, better navigate the near-term as we continue to focus on medium-term outcomes.

This Insight sets out our views, the risks, and the implications for investors over the near-term.

The Fed will probably not cause a recession this year.

US economic data are slowing rapidly. The housing market is in free fall. The manufacturing and services sectors are contracting. Wages growth has slowed. Core inflation has peaked and is slowing quicker than most investors and central banks had anticipated. Inflation expectations point to the Fed missing its inflation target on the low side over the next decade.

But the Fed insists it will need to hike further and hold rates at restrictive levels for longer than the market currently anticipates. Unfortunately, the Fed has limited credibility in rates markets right now. And data are screaming at the Fed to pause sooner rather than later.

We expect the Fed will pause in Q1 2023. Rates are likely to remain at those restrictive levels for some time. Potentially for 12 months. The Fed will probably not cause a recession this year if the Fed listens to the data and pauses.

Insights: The year ahead
Jan 2023

A pause in early 2023 will be a positive outcome for equity and bond markets in the near-term. We expect this could be supportive of developed market equities including the US and Australia.

Risks: We remain aware of the risk from recession. The inverted yield curve – the difference between the 10-year US Treasury yield and the 2-year US Treasury yield – has historically preceded US recessions. Picking a recession timing is difficult. If the Fed hikes too far, they could cause a recession in early 2023.

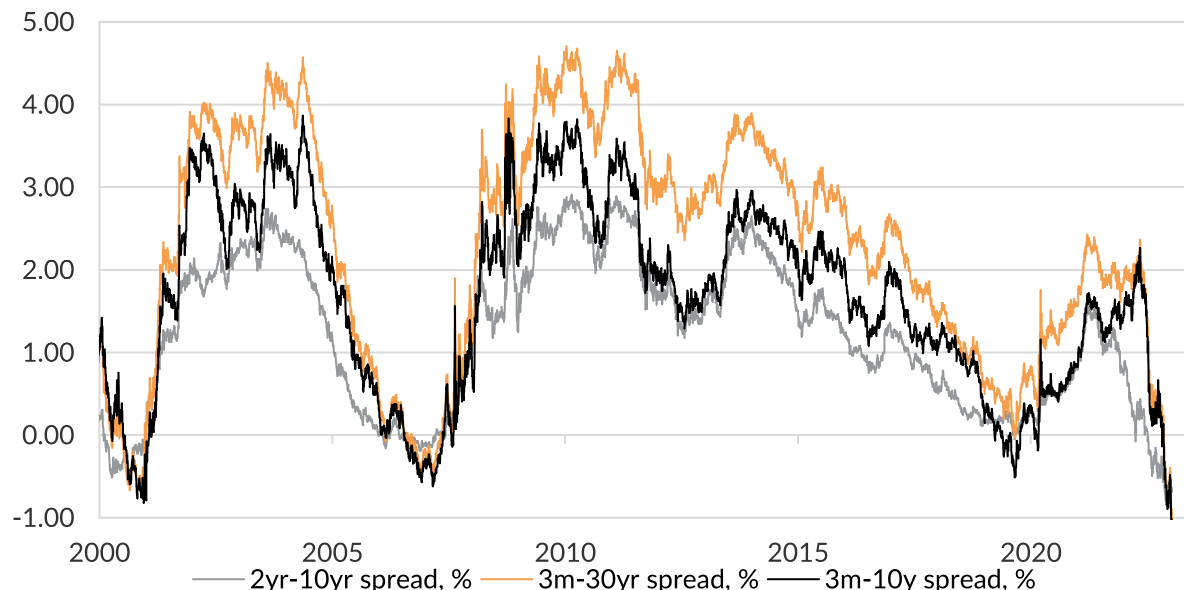
We think the best signpost for the timing of a recession will be a focus on shorter-dated US Treasury yields. Historically, a collapse in the 2-year yield that normalizes the yield curve – moves it from negative to positive – is a good indication that recession is imminent.

Implications: The sequencing of these potential outcomes presents challenges from an investment perspective. We make the following observations.

a. Government bonds look attractive: Yields remain relatively elevated in our view. We think high quality government bond yields – US Treasuries and Australian Government bonds in particular – offer an attractive downside protection, income and diversification benefit through 2023.

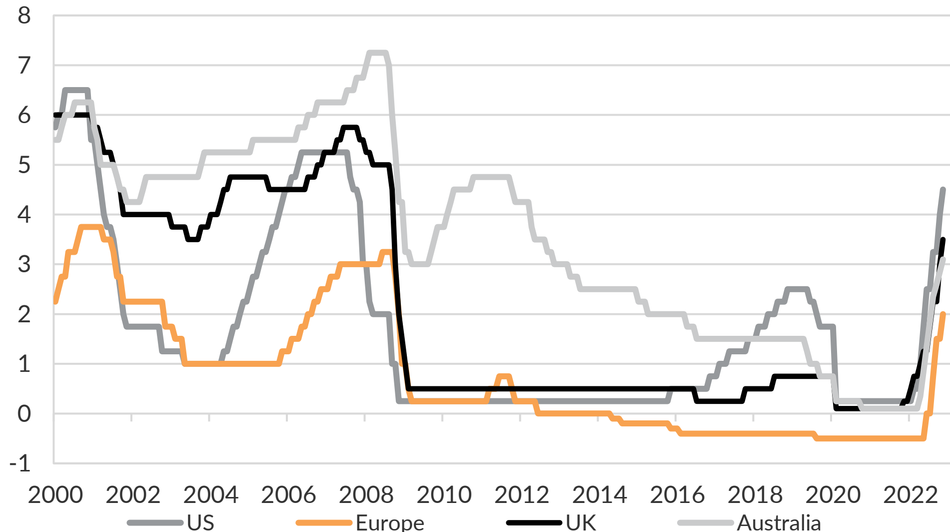
b. Remain near strategic asset allocation weights in developed market equities: The near-term outlook for equities depends crucially on the Fed's monetary policy decisions. We expect there could be more upside. But risk is skewed to the downside over the medium-term, leaving us at a neutral setting for equities.

Chart 1: The yield curve is deeply inverted across the US yield curve, and that has always preceded recession.



Source: Bloomberg LP, Oreana

Chart 2: Global central banks, led by the Fed, hiked rates aggressively and may pause early in 2023, extending the economic cycle.



Source: Bloomberg LP, Oreana.

China is not uninvestable.

China experienced its own recession through most of 2022. Through 2022, China was seen as "uninvestable" by some foreign investors. Investors faced regulatory challenges, zero-Covid lockdowns, a National Congress and ongoing atrophy in the housing sector. But China's economy began to reopen in October. By December, the reopening was clear to see. As we begin 2023, that reopening has some way to go and will continue to be supported by fiscal policy and regulatory support.

We expect the real story for investors will be pent up demand from mainland households. That will show itself in increased tourism, increased domestic demand, and a support to global growth. We expect China's reopening will be especially positive for Asian economies. A good bellwether for Chinese demand will be HK tourism from mainland China.

Risks: China's abrupt shift to reopening caught many by surprise – despite the clear signals that began in October 2022. There is no guarantee that China will not reintroduce lockdowns or restrictions. Furthermore, China's households may choose not to resume spending and traveling in line with pre-Covid trends.

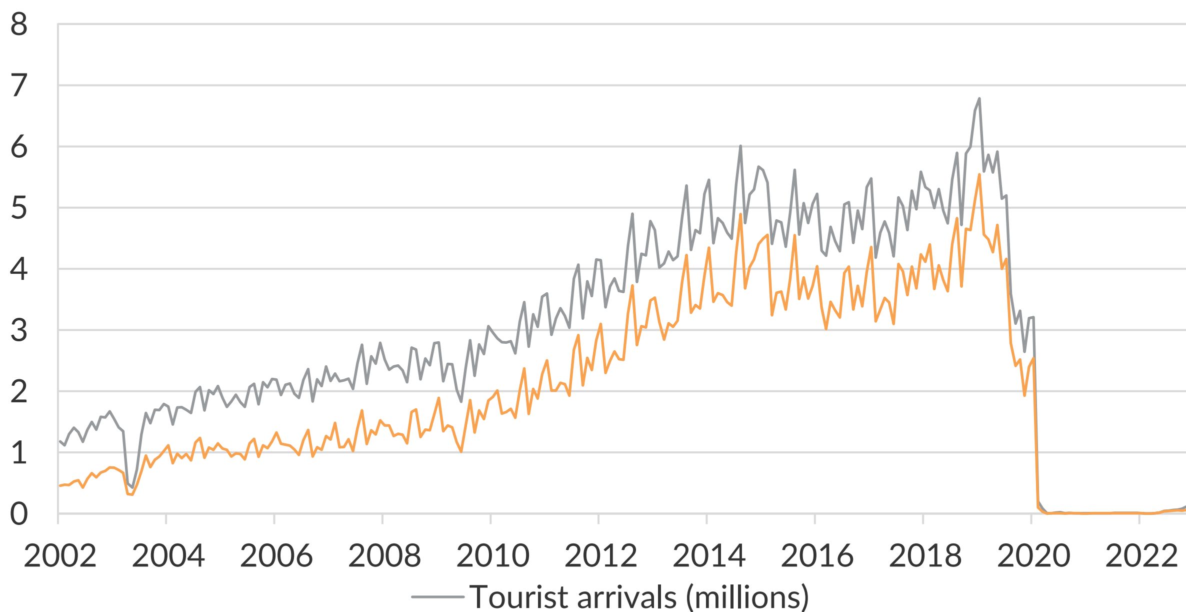
Globally, China poses geopolitical challenges to risk appetite. We expect China will continue to pursue its own interests and that could place it at loggerheads with some developed markets, particularly the US. Furthermore, the reopening could result in China exporting inflationary pressures to the rest of the world, causing developed market central banks to hike rate even further that is necessary to control domestic inflation.

Implications: China's recovery and rebound from recession provide upside risks to global equities. However, there is also important implications for bond yields.

Insights: The year ahead
Jan 2023

1) Asian equities could be an important source of alpha: China equities and Hong Kong equities had already rebounded sharply by January 2023 from their October troughs. We expect there could be more upside as China exits its recession, supporting growth throughout the Asian region.
2) Australia should benefit: Australia's equities outperformed global counterparts through 2022. We expect that trend to continue through 2023. That will be supported by a less aggressive central bank, but importantly, but the resumption of trade in key goods with a reopening China.
3) Inflation remains an uncertainty: Inflation peaked in the US in early 2022. But China's reopening poses a near-term threat to inflation. We are not sure if China will export inflation or disinflation pressures globally. But at the margin, we lean toward China exporting some inflationary pressure. We think that will be a positive, as it will reduce the risk of outright deflation through 2023 in the US, and may help delay a recession.

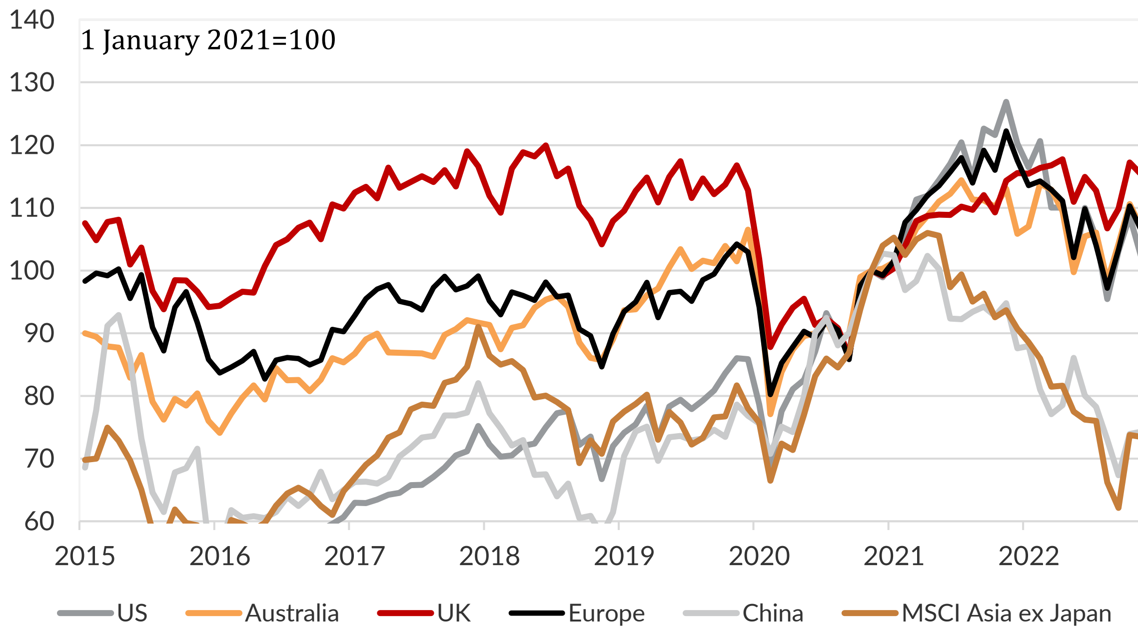
Chart 3: HK tourist arrivals from China will be a key bellwether for Chinese demand through 2023.



Source: Bloomberg LP, Oreana.

Chart 4: China's equity markets underperformance recovered in Q4 2022 and could improve further through 2023.

Insights: The year ahead
Jan 2023



Source: Bloomberg LP, Oreana.