



Investment review

Fourth quarter 2022

Capital markets ended the year on a positive note. Global equities edged higher by +9.76% during the fourth quarter in USD terms. Meanwhile, US Treasury 10-years returned a total return of +0.61% in the final quarter. Other trends also partially reversed: US dollar strength faded, while cryptocurrencies declined after FTX filed for bankruptcy, with bitcoin falling by over 14% (USD terms).

Overall, it was a difficult year for both stocks and bonds. Global equities fell by -18.36% in USD terms, but bond markets experienced their worst year in decades. US 10-years yields ended 2022 at 3.87% from 1.51% at the beginning of 2022.

During the final quarter of the year, economic activity momentum continued to slow albeit unevenly, inflation rates appeared to moderate from their multi-decade highs – particularly in the US – and central banks continued to hike policy rates. Geopolitical risk remained in focus: Russia's attack continued despite Ukraine's advances; US-China tensions somewhat eased following high-level talks between Presidents Biden and Xi Jinping; and UK political turmoil subsided.

The US economy expanded by 0.8% in the third quarter, recovering from the modest recession during the first half of the year. That momentum likely continued into the fourth quarter, with the Atlanta Fed's real-time estimate of growth tracking at a healthy 1%. A gradual slowdown was more evident in Europe: the euro area economy only expanded by 0.3% in the third quarter, while UK activity contracted by 0.3% (the data were still slightly better than expected). Even so, there were some bright spots: the euro area unemployment rate stayed at a record low of 6.5% in October. Headline inflation rates turned lower across most developed economies, though remained elevated. The improvements were most visible in the US data: the headline inflation rate moved lower for five consecutive months, falling to 7.1% (year-over-year) in November. Headline CPI inflation remained higher in Europe but may have also just peaked: the UK figure edged down to 10.7% in November – after the energy price cap raise in October – as did the euro area data, now at 10.1%.

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Moreover, core inflation rates – that is, excluding food and energy – also moderated, though the declines were less pronounced. In the US and UK those rates were close to 6%, while euro area core CPI inflation remained at a record high of 5%. Nominal wage growth was still robust in the US and UK but continued to lag inflation in 2022 – real wage growth remained firmly in negative territory. The Federal Reserve (Fed) raised its target interest rate by 125 basis points (bps) over the quarter to the 4.25–4.5% range. The pace of tightening slowed, with “only” a 50bps hike in December, but the Fed Chair, Jay Powell, retained his hawkish tone. The updated economic projections showed that most Federal Open Market Committee (FOMC) participants expect the policy rate to remain above 5% at the end of 2023. In Europe, the European Central Bank (ECB) continued its hiking cycle, increasing its deposit rate to 2%. In addition, it stated that it would start passively reducing its balance sheet from March 2023 onwards. The Bank of England also raised its base rate to 3.5%, though appeared more hesitant: two of the nine voting members actually voted for “no change” at the December meeting, seemingly due to domestic growth concerns. Separately, the Swiss National Bank (SNB) increased its policy rate by 50bps to 1%. Elsewhere, the Bank of Japan (BoJ) continued to buck the global trend, leaving its main policy rate unchanged this year. That said, the Bank widened its “yield curve control” band for 10-year government bonds to +/- 50bps (from 25bps previously).

Inflationary pressures also increased: the headline inflation rate almost reached 4% in November. China experienced a turbulent quarter. As anticipated, Xi Jinping secured his third term at China’s 20th National Congress in October, but he also appointed several personal connections to the Politburo and its Standing Committee – further cementing his position. Economic activity continued to be constrained by tight COVID-related restrictions and the ongoing property market weakness, with the annual 2022 growth rate downgraded further. Nonetheless, growth prospects may improve going forward: Beijing has started to abandon its longstanding zero-COVID policy, with measures being relaxed, while policymakers pledged further stimulus at December’s Central Economic Work Conference.

In the political sphere, the Republican clean sweep failed to materialise in the US midterm elections, as the Democrats retained control of the Senate (but ceded control of the House). UK political turmoil eased after Rishi Sunak replaced Liz Truss as Prime Minister. The new “new” administration’s fiscal projections confirmed a significant net loosening of fiscal stance in the two years running up to the next election (likely in January 2025). Meanwhile, the outcome of COP27 appeared to be mixed: the creation of a “loss and damage” fund offered some burden sharing, but there was still little progress on further reducing fossil fuel usage.

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MARKET REVIEW

Both global equities and bonds rallied in the final quarter of 2022. Developed market equities returned +7.5% in the fourth quarter – though were down by 16% for the year as a whole – while emerging market stocks rose by 6.6% in the final quarter of the year (all in local currency terms). There was a broad-based rally across regions, including North America (+6.9%), the euro area (+12.8%) and the UK (+8.6%). EM Asia also returned +7.7%, after COVID-related restrictions started to ease in China. Sector-level performance was slightly more mixed, though almost all had positive returns in the fourth quarter: Consumer Discretionary (-4.8%) and Communication Services (-1.2%) were the only two exceptions. Energy (+17.1%), Industrials (+14.1%) and Materials (+13.1%) were the best-performing sectors.

In fixed income, global government bonds rallied by 4.8% over the quarter (unhedged, USD terms). The US 10-year government bond yield rose to a year-to-date high in October (4.24%), before moving down to 3.87%. Similarly, the real yield equivalent (TIPS) reached 1.75% in November, before moderating down to 1.58%. UK Gilt market volatility subsided after September's political turmoil: the UK 10-year Gilt yield ended the quarter at 3.67%, while the 30-year benchmark yield fell below 4% (the

latter briefly breached 5% in September and again in October). On the other hand, euro area benchmark yields ended the quarter higher, particularly after the ECB's hawkish messaging at its December meeting: 10-year Bund yields ended the quarter at a year-to-date high of 2.57%, though the 10-year Italian BTP to German Bund spread remained close to two percentage points.

Broader commodity prices edged higher over the quarter (in USD terms). Both precious and industrial metals exhibited strong gains, notably gold (9.8%), copper (8.9%) and iron ore (16%). Energy was perhaps the exception: Brent Crude oil fell by 2.3% to \$85.90 per barrel – though briefly touched a year-to-date low during the quarter – while natural gas prices dropped sharply in the euro area (-59%) and UK (-47%), now well below their summer highs. Agricultural commodities were mixed, but wheat prices (CBT) declined by 14.1% on the quarter. Finally, in currency markets, US dollar strength partially reversed, down by 4.7% (on a nominal trade-weighted basis). Both the pound sterling and euro were up by 2.2% and 4.2%, respectively.

All investment returns quoted are in local currency terms and sourced from Avaloq. Index returns are sourced from Bloomberg.

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