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In 2022 inflation returned with a force not seen for forty years. This was especially true in western economies where a confluence of forces, mostly Covid related, drove up prices. During 2020 and 2021 western governments provided huge monetary stimulus and organised generous relief packages to alleviate the Covid pandemic. The surge of spending in a world where many production facilities were running at low capacity, due to supply constraints caused by Covid, led to soaring price increases. This situation was exacerbated by the Russian invasion of Ukraine which led to tighter markets in oil, gas and wheat. Moreover, Covid changed the labour market, leading to labour shortages. A combination of health-related concerns and over generous welfare led in the US to the lowest worker participation rate for forty years. With nearly two jobs available for every unemployed worker wage pressure has been strong. This sharp and persistent inflation led to a belated reaction from the Federal Reserve to tighten liquidity, and both the bond market and stock market suffered sharp setbacks. In 2022 the US 10-year bond fell 14.7%, the German 10-year bond fell 18.6%, while the longer dated Austrian 2086 bond fell over 50%. In equity markets the S&P 500 index declined 19.4%, the MSCI Europe Index fell 14.9% in US dollars, and the MSCI World Index declined 17.5%. The US dollar was the strongest major currency rising by 6.2% against the euro and 12.5% against the yen. Very few asset classes managed a positive return for the year, and the largest falls were in the popular areas such as US technology stocks, the Nasdaq was down 33%. The outcome of this turmoil was an estimated $35 trillion wiped off financial wealth.

The strength of inflation caught policy makers by surprise. After a long period of keeping interest rates at close to zero, the Federal Reserve raised rates from 0.5% in April to 4.5% in December. While this is a level much lower than the rates that prevailed in the 1970's and 1980's the size of the debt now is far greater, so the impact is much more forceful. A 5% US interest rate today generates the same burden as a 15% rate in the 1980's. It also marks a reversal in policy. Since 2008 governments have reacted to any economic weakness or problem by lavish spending packages, borrowed at exceptionally low rates. Rising interest rates make this policy much more expensive, and bond markets are challenging the limits of how much governments can borrow. Most dramatically the market reaction to the UK mini-budget at the end of September suggested the end of governments being able to spend without a credible plan of how the debt would be repaid. The era of indulging in huge fiscal deficits at very low interest rates is over. This leaves governments with a problem. How do they balance the need to cure inflation with the equally urgent need to kick start growth? Most major economies face an awkward mix of rising indebtedness, rising interest costs, ageing workforces, and bloated welfare systems that have been kept running by Central Bank printed money issued at low interest. The new reality requires solutions that will be more difficult politically. These include raising interest rates to curb the debt bubble, tackling welfare inefficiency, and raising retirement ages. Against the background of a cost of living crisis these measures will be even more difficult, but if Governments/Central Banks are too profligate interest rates will rise, or their currency is likely to suffer. The good news is that some of the upward pressures on inflation are abating. The recovery from Covid is allowing supply chains to operate again, and shortages and bottlenecks are disappearing. From the highest point in 2022 inflation will almost certainly decline, but it will be hard to get back to a 2% level. The pressure on wages remains firmly up. For the first time in human history the number of young entering the workforce is falling, while the working-age population is contracting, estimated at a rate of ten million a year or 27,000 a day. As the labour force shrinks employers have to compete with money to attract workers. There are many stories of businesses closing not from the lack of demand, but from the inability to secure labour. It is a structural problem not easily fixed, one cannot print two million workers to solve this shortage, and it is inherently inflationary.

One of the most interesting places to monitor inflation in 2023 will be Japan. Since his arrival in 2013 Kuroda, the current Governor of the Bank of Japan, has held 10-year bond yields below 0.25% in an attempt to stimulate inflation. In December he lifted this artificial limit to 0.5%, still an extremely low level when compared internationally; Switzerland's 10-year yield is about 1.5%, Germany's about 2.5% and the US approximately 4%. Kuroda retires next Spring and this move may herald a change in policy which would allow Japanese yields to rise. The international significance of this lies in the vast savings of Japanese households, estimated at approximately $12 trillion. With yields so low at home the Japanese have been forced to search for returns elsewhere. These savings have irrigated world markets for the last twenty years. Japan is the world's leading creditor with $3.6 trillion of net assets overseas, including 9% of France's sovereign debt, 7% of the UK's and 6% of the US. However, if bond yields rise in Japan it would be natural that some of this money returns home. This could be a slow process, but it would put upward pressure on bond yields outside Japan, and other high yielding assets, and probably other popular areas such as the giant technology stocks and real estate.

The drift of the world to balkanise as the US attempts to constrain China, and Russia is ostracised, puts upward pressure on many traded goods and commodities. The disruption caused by Russia's invasion of Ukraine has had the most effect on commodities as far as financial markets are concerned. However, a disruption to China's role in the world would be far greater. Decades of investment have created a huge ecosystem of logistics and supply chains in China which are efficiently blended with the rest of the world. 98% of Apple's iPhones and 70% of global smart phones are made in China. A Bloomberg article estimated that it would take Apple eight years to move just 10% of its iPhone production out of China. Food and energy remain vulnerable to trade disruption given the current stand off between Russia and the West. Historically geo-political risk was best managed with very high inventories. It is therefore concerning that inventories are low, for example, the US Special Reserve of oil has been depleted by a third during 2022, leaving it at the lowest level since 1984. Over 80% of the world's energy still comes from fossil fuels, but the investment in replacing reserves has collapsed at the expense of investment in renewable energies. A report by Rystad stated that capital investment in renewables ($494 billion) overtook that in oil and gas ($446 billion) in 2022. Thus, the world spent more on 4% of its energy supply than on sustaining 80% of its existing supply. The problem is exacerbated by many governments subsidising demand and taxing supply, for example, the UK is taxing the producers of its North Sea energy fields, capping consumer energy prices, and sending a cheque to subsidise every household's energy consumption. At a time of shortage this is madness, and ultimately unsustainable. Further, a new order is forming in oil markets leaving the world even more dependent on OPEC. The starkness of the situation is illustrated by the change in US relations with Mohammed bin Salman, the Saudi heir apparent. Formerly a pariah for his alleged role in the murder of Jamal Khashoggi, in July President Biden went to Saudi to plead with him to increase their oil supplies, with little success. The lack of investment in western oil supply derives from the desire to decarbonise world energy. However, the risk is clear. With renewable energy supplies struggling to achieve critical mass, fossil fuel prices could rise significantly. In 2022 energy prices fluctuated wildly in response to the Russian invasion, but were held in check by China's lockdown and the raiding of the US Reserve. In 2023 China should reopen and the US Reserve will need to be refilled. Environmentalists detest the use of oil, but the world remains built on a fossil fuel model. There is a big conflict between the E and the S of ESG. The lack of investment in fossil fuels will hit the poorest in society the hardest, and this reality is forcing a rethink. The Greens in Germany spent years in opposition trying to reduce the carbon footprint. For the first time they made it into government and within months had to agree to restoring coal power, an epic volte face. The net zero target (cutting greenhouse gases to zero) is a laudable aim, but it needs to be achieved in a way that retains prosperity.

How should an investor position themselves in this unsettled environment? The easiest answer is to avoid areas that will be hurt by rising/higher interest rates, or countries which will suffer from the world de-globalising. As yields rise bonds become more attractive though they are hardly compelling against inflation. The problem for equity investors is that the popular stocks are over owned, largely as a result of ETFs which repeatedly bought the same large stocks. But there are some very cheap stocks. Most of them are outside the US where markets have been far less strong. The MSCI Pacific Index touched the same level in October as it had in 1989. The MSCI Europe Index and UK FTSE Index are much the same as they were in 2000. There are plenty of companies in all these areas that are performing well and sell on attractive valuations. The reopening of China should support the Asian and Emerging Markets, which also have far lower inflation than the West. It is curious to see that Brazil has a lower inflation rate than Germany. Generally, Emerging Markets have followed a much more orthodox approach during the pandemic, and don't have excess debt levels from fiscal handouts. China's reopening is likely to follow a stop-start pattern, but foreigners are underweight so, if the recovery takes hold, there could be a rush to re-enter this huge market. Japan also looks a safe haven with many companies with strong balance sheets and steady earnings growth, and a restructuring story that is gaining momentum. In terms of sectors the rising tensions around the world mean that defence companies are performing well. The structural shift to decarbonisation is commodity intensive which supports a multi decade trend for the relevant commodity producers.

Many of the issues that rocked markets in 2022 remain. Inflation is sticky and interest rates are likely to stay elevated. These higher rates will be problematic for countries, companies or individuals who need to refinance over the next twelve months, as they will pay a much higher amount than they have become accustomed to in the past decade. Companies are also facing higher wage bills. Together these will hurt margins. With interest rates over

4% and the Fed still in hawkish mode it would not be a surprise if equity indices gave back most of their gains since the Covid inspired boost in early 2020. As an extreme example, Tesla could fall more than 70% and still be a $100bn company. But the indices are full of the large stocks that have dominated performance in the last decade. It is a feature of bear markets that leadership shifts from one group of stocks to the next. Potential candidates for those future opportunities lie mostly outside the US, particularly if China recovers and the US dollar falls. In terms of sectors, commodities have the tailwind of the decarbonisation trend, and financials will benefit from higher interest rates. The areas that have been neglected look the most attractive. The immediate future appears a much more attractive environment for active investment management than passive investing linked to indices.