INVESTMENT POLICY NOTES

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2022 was an unusual year. For the first time in decades OECD bonds became positively correlated to equities, and both fell dramatically. However, there were signs that markets were beginning to move in a different direction to that of the last decade. Technology stocks had a poor year and there is little sign that this will reverse. Meanwhile Emerging Market bonds and equities outperformed their Developed Market equivalents. This was particularly noteworthy given the strengths of the US dollar and the China lockdown. The one sector to perform well was energy, and with Russia's invasion of Ukraine energy is likely to continue to dominate headlines. Gold also started to perform better after a long period of drift, and this may be signalling the end of the dollar's supremacy.

In 2023 China's reopening of its economy after three years of strict lockdown will be the most important macro event of the year. China's stock market has suffered a 40% decline relative to the World Index since 2012, and even more against the rampaging US markets. But the outlook is much better. The Chinese market has started to recover, pushed by the Chinese retail investor. Chinese households have the most cash in the bank ever because of their inability to spend during the last three years. This cash hoard is estimated at RMB14.8 trillion. There is massive pent up demand and mortgage and auto loan rates are low, which will stimulate consumption as the Chinese population is released. Following years of poor performance foreign investors have given up on China, so the marginal seller that has accounted for recent underperformance has disappeared.

The reopening of China is inflationary. It is likely that the same pattern will occur in China as took place in the West following their re-openings. That is there will be labour shortages as the return to work is interrupted by waves of Covid. Companies, particularly manufacturing ones, will need to overstaff to cover sick leave absences. This will make labour markets very tight, and lead to periodic supply issues. China's recovery will also be positive for energy demand. Energy supply is already tight and demand will rise with the recovery. There has been a geopolitical shift as Russian oil has been redirected to China, away from the West. The blowing up of the Nordstream pipeline has forced Russia to turn East. China will enjoy an advantage as it is able to buy oil at a discount to world prices. This applies to all commodities and because Russia is the world's largest commodity exporter and China the world's largest commodity importer, the fact that they are dealing off market will make pricing opaque and commodity prices will probably be more volatile.

The message for world markets at the start of 2023 is that everything from China looks inflationary. China's poor handling of Covid means that it has to make a success of its reopening. This will lead to higher commodity prices, higher wage growth, and more demand. This view is in contrast to the general view that inflation will come under control during 2023. The long period of disinflation looks to be over, and we are entering an era of inflation. This has significant implications for portfolios. Most portfolios are set for disinflation – they are full of bonds and technology stocks. In an inflationary world bonds don't offer protection. Portfolios need to adapt to reflect the new world. The outperformance of Emerging Markets, commodities and financials point to the new areas of leadership.

2022 looks like an inflection point. The winners of the last decade look tired. The Chinese reopening should spur an outperformance of Emerging Markets over Western ones. The US market looks expensive relative to both Emerging Markets, Japan and Europe. There are also signs that the US dollar may be rolling over. Over a longer view investors should be looking to position themselves to benefit from the decarbonisation theme, the recovery of financial stocks and outperformance by precious metals. The areas to be more cautious include the US dollar, bonds, and bond proxies such as real estate and large cap growth stocks.