Global Investment Strategy

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Mitsubishi UFJ Asset Management (UK) Ltd. (Registered in England No 1842259)
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Investment Summary

Positive signals – rising business confidence, falling inflation expectations.

Still no recession, but increasingly it looks like a low growth environment without ultra low interest rates.

Central Banks may yet raise rates further, to ensure inflation pressures are extinguished.

Inflation pressures still arise from energy prices, tight labour markets, the war in Europe, and Covid.

This is a year of consolidation, there are better times ahead but is that 2024 or further out?

The rate of inflation is falling, but price levels are high and the cost of living is in crisis.

Individuals will continue to worry about energy bills mortgage payments, and general living costs.

Corporates have to manage their costs, the cost of borrowing, labour and other inputs are rising.

Do they push up output prices or do margins get squeezed? Either way profits are under pressure.

Central Banks are still in tightening mode.

Monetary policy is not tight, but it is tighter than it was and we still do not know where the neutral rate lies.

The consensus view remains: soft productivity growth in the future and a general lack of bold action.

Equity markets seem to be focused on interest rates and not growth.

Profit expectations will take time to stabilise, and it is hard to visualise a strong rebound at present.

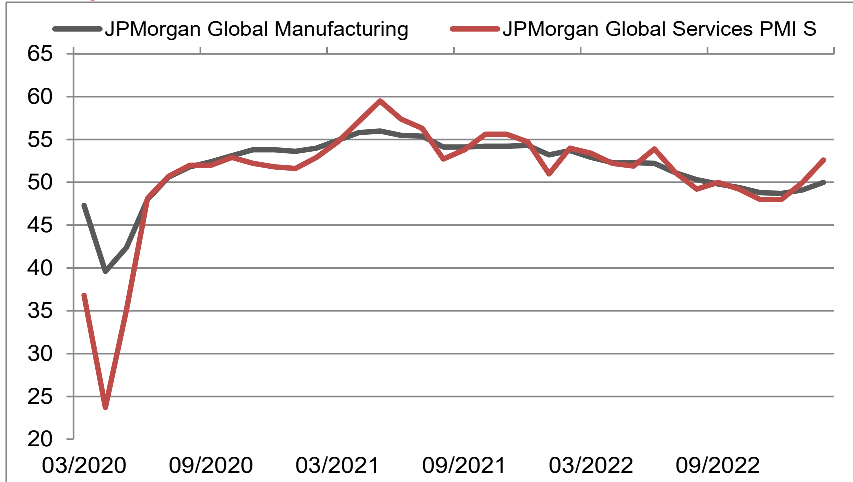
Growth and profit factors were rightly the poorest performers in 2022, expect this trend to remain.

Costs are rising, worker pay, fuel, and on top of these there are the costs of climate change.

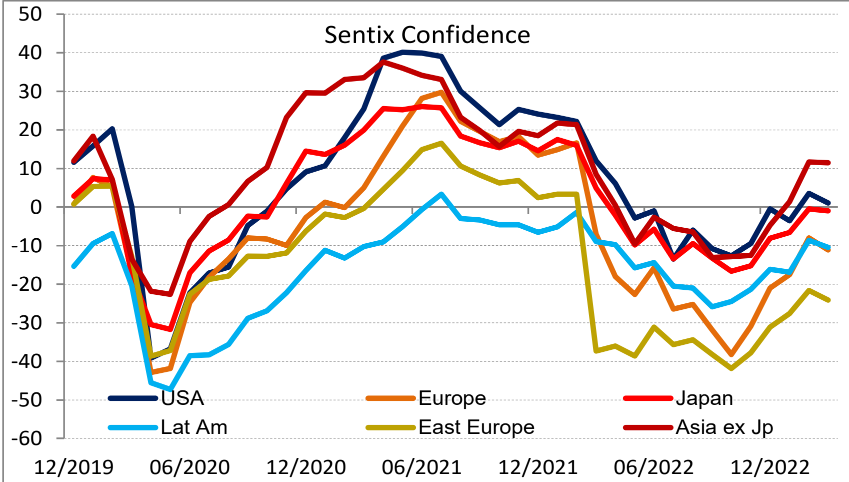
Growth and Inflation

Source: JP Morgan, Sentix, OECD, Bloomberg,

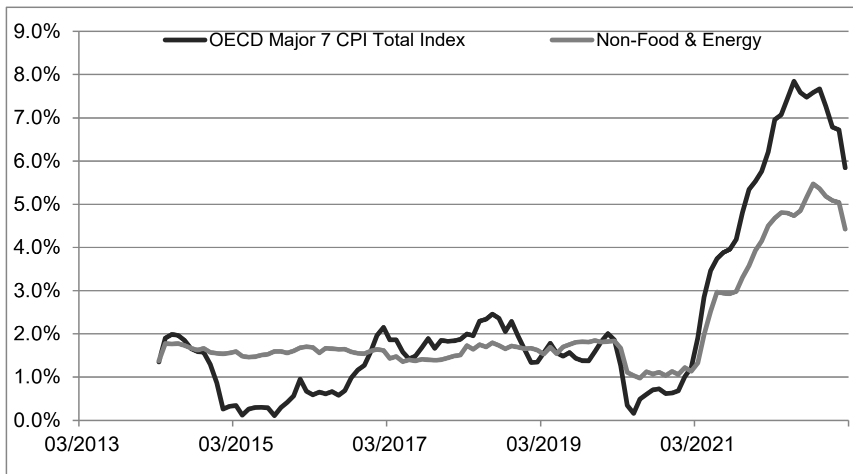
JP Morgan Global PMIs



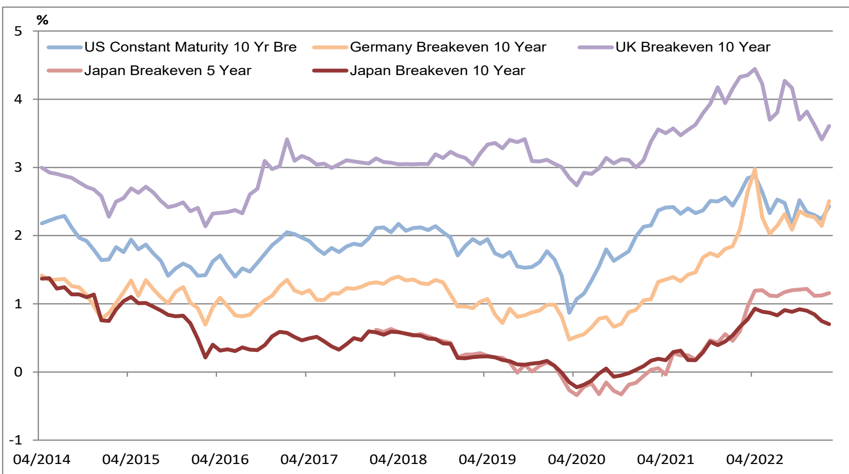
SENTIX Business Expectations Survey



OECD G7 Inflation



Implied Inflation from Index Linked Bonds



Commentary

What are markets telling us?

The US yield curve is inverted, rates expected to peak above 5% and eventually settle below 4%.

German peak above 3%, UK peak at 5%, Japan at 2%; after the peak a slight rally but not much else.

Inflation is the key to policy, will higher rates be needed? There may be several false dawns this year.

Equity markets discount more of the same, some profit growth and limited change in valuation.

Currency movements suggest that the USD has run its path and that local interest rates will dominate levels.

What are we thinking?

We are in a quiet period waiting to see where and when rates peak and the shape of any recession.

Supply chains are normalising, but labour markets remain tight and the war in Ukraine continues.

Inflation pressures are expected to fall, but price levels remain high, causing consumer pain.

There are risks from: higher wages pushing inflation higher; or higher rates leading to recession.

We are confident central banks will take action to meet inflation targets.

The BOJ will have a new governor this month, does this signal policy change? Do not hold your breath.

China has reopened, but longer term challenges remain, however it eases some inflationary pressures.

US and Germany have the same inflation expectations, so markets suggest US real rates will be higher: why?

Higher interest rates and high levels of energy prices are detrimental to growth.

Corporate profit margins must be under pressure, and productivity is not going to rescue them.

Fixed Income

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Fixed Income Strategy (1)

DURATION

We are slightly long duration overall.

Short ends need to decide what rate level is needed to bring down inflation.

Longer term rates need to decide where things settle a few years from now.

Given the downside risks the higher yielding markets' longer ends are moderately attractive.

However debate in academic circles rages over neutral rates.

On valuation grounds we are therefore a little long the higher yielding markets and flat elsewhere.

SPREAD PRODUCT

Spreads have moved out as risks rise.

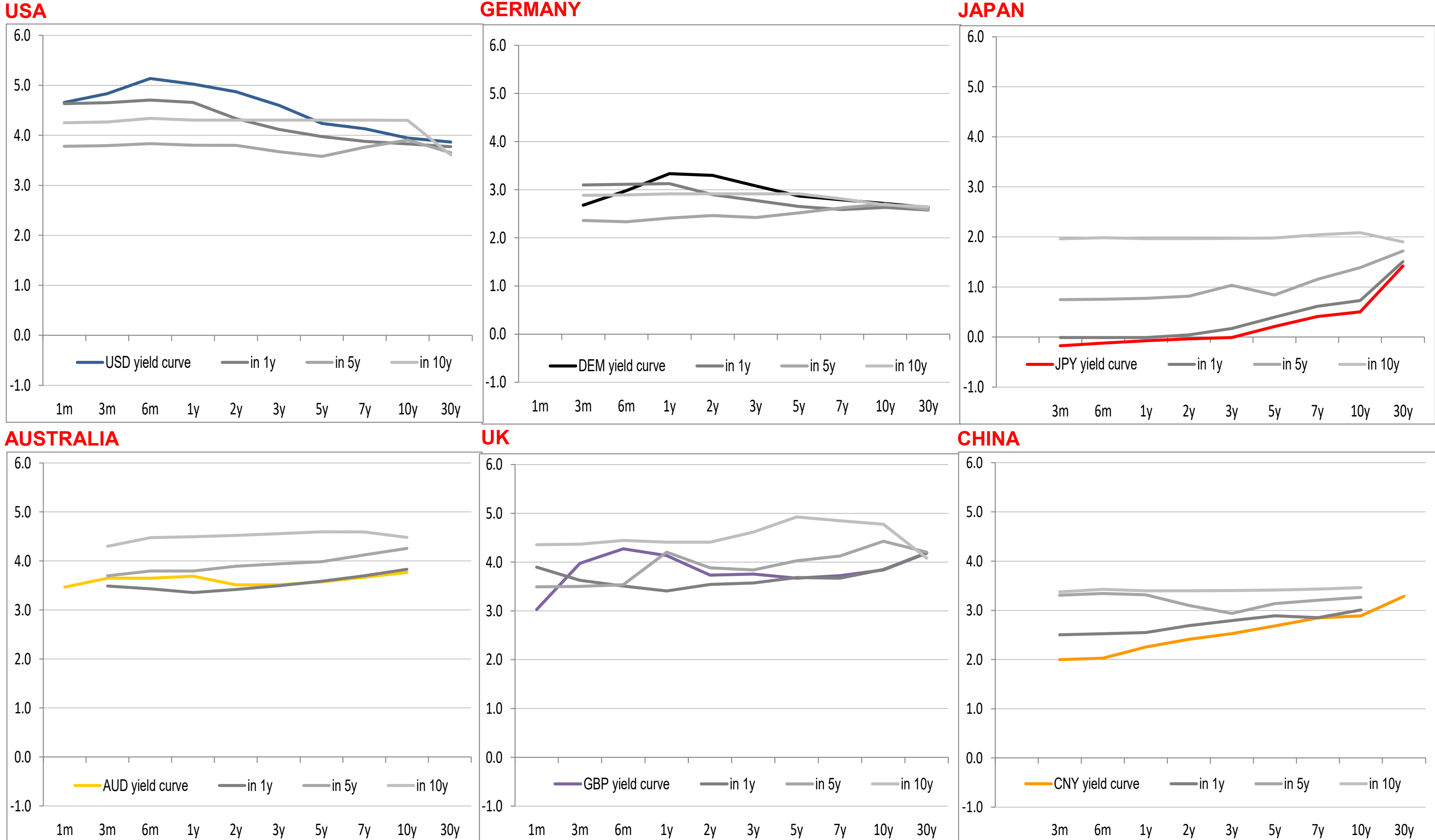
The war in Ukraine through terms of trade shock (commodities) and escalation risks had hit spreads.

Corporate OAS is at 130bp, still somewhat high, but has rallied sharply as tail risks have diminished.

We maintain a moderate long position, but now more for income than for spread compression.

Forward Yield Curves

Source: Bloomberg,



Fixed Income Strategy (2)

COUNTRY ALLOCATION

We have preference for US/UK rates over EU.

US forward curves put US rates in the distant future way higher than EU rates - in the long run that is wrong.

Inflation expectations are the same, so real interest rates are higher in the US.

The US and EU central banks are clearly, and rightly, aggressive about inflation targets.

We need higher unemployment and weaker wage growth to see markets settle.

It remains uncertain where rates need to go to achieve this.

UK forward rates slightly above the US appear wrong, the UK market is relatively attractive.

CURRENCY

We have limited currency positions.

USD positives: stronger economy, energy exporter, higher rates, risk aversion, less exposed to Ukraine.

USD negatives: current account deficit, overvalued, subject to rates consensus.

Better EU economic data and a more hawkish ECB have boosted the Euro.

The USD may bounce on data, but longer term the tide has likely turned.

Japan's loose monetary policy has created a very cheap Yen, it has a long way to go when things change.

Equity

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Equity Strategy (1)

GLOBAL

Global profits are rolling over, and profit expectations have begun to fall.

Global corporate earnings have peaked and growth is slowing, this bull cycle is over.

Hopes of an investment led recovery are disappearing, and the bond market no longer provides cheap cash.

Profit margins are at high levels, it is hard to see how these can be sustained in a cost of living crisis.

High inflation boosts nominal data, and it is important to realise that real growth is actually looking quite poor.

Valuations have risen as equities rallied with the bond market even with lower earnings forecasts.

MSCI 12m forecast growth is at 14%, but the market expects low single digits profit growth.

The historic MSCI P/E is at 18.6x and the P/E a year ahead is at t6.2x.

Dividend Yield is at 2.18%, below long term interest rates, and not suggestive of strong returns.

Corporate cash flow has many demands – investment, wages, dividends, – who will win out?

Corporate managements have some difficult questions to answer, in particular how to live without free money.

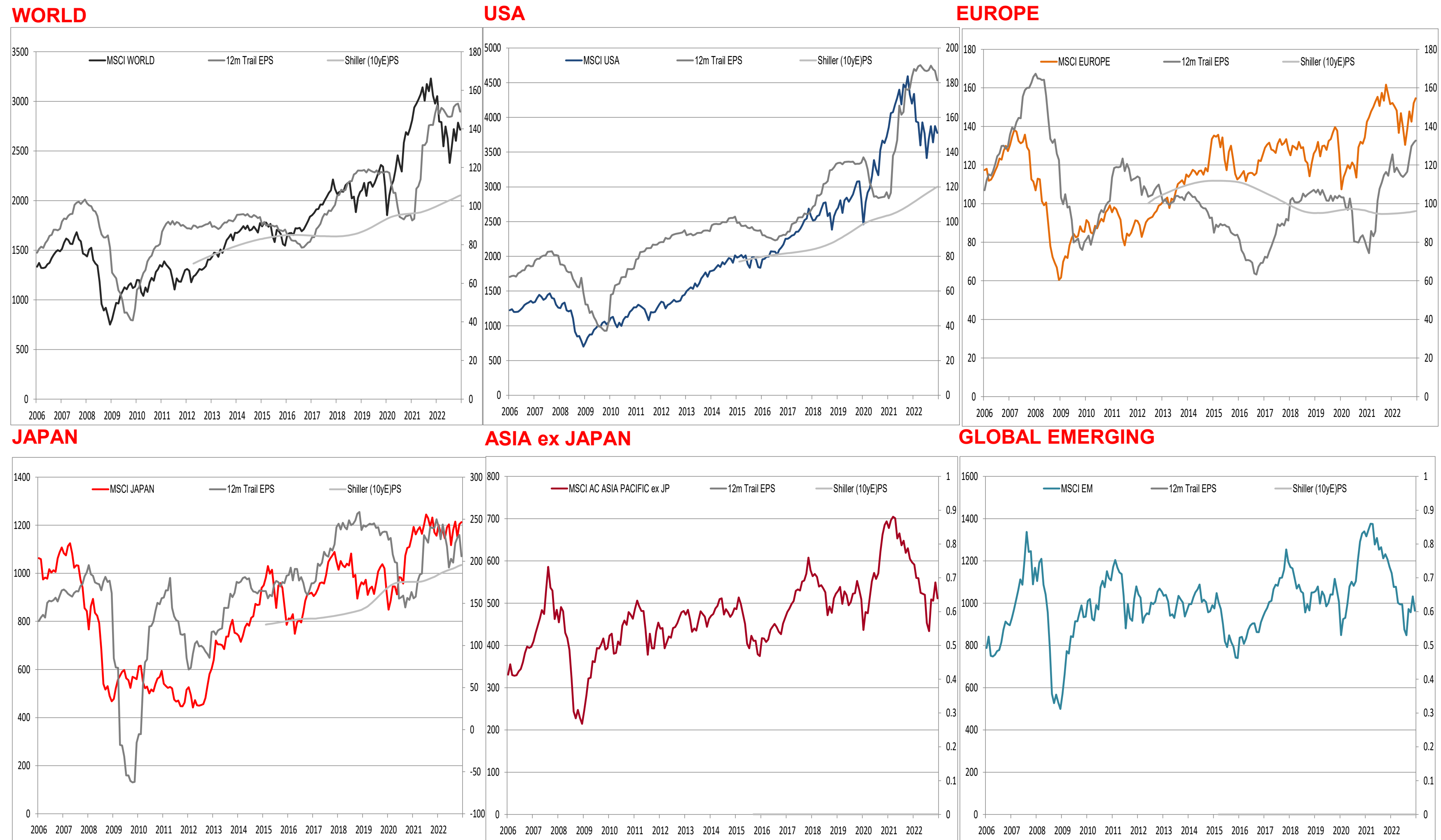
Investment is needed to boost capital, pay for a greener future, and to raise productivity.

But labour is tight and demanding higher wages, and suppliers cannot be squeezed as they have been.

As interest rates rise shareholders will need higher returns.

MSCI Equity Indices and Earnings (right hand axis)

Source: MSCI, Bloomberg,



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Equity Strategy (2)

SECTORS

Technology and Consumer Discretionary are in downtrends – no more easy money.

The Technology sector has been making headlines for the wrong reasons, earnings disappointments.

Defensive earnings are seeing relative strength; Consumer Staples and Healthcare are moving ahead.

Could 2023 be the year of the Bank as well as the Rabbit? Improved interest rate structures at last.

Long term growth stocks will remain under pressure as discount rates provide a headwind.

FACTORS

2023 – low growth, above target inflation – no strong trends expected

It is typical to see several bond bull markets during a rise in interest rates, do not get sucked in.

We are currently trendless, Momentum is the weakest factor, Trading and Volatility the strongest.

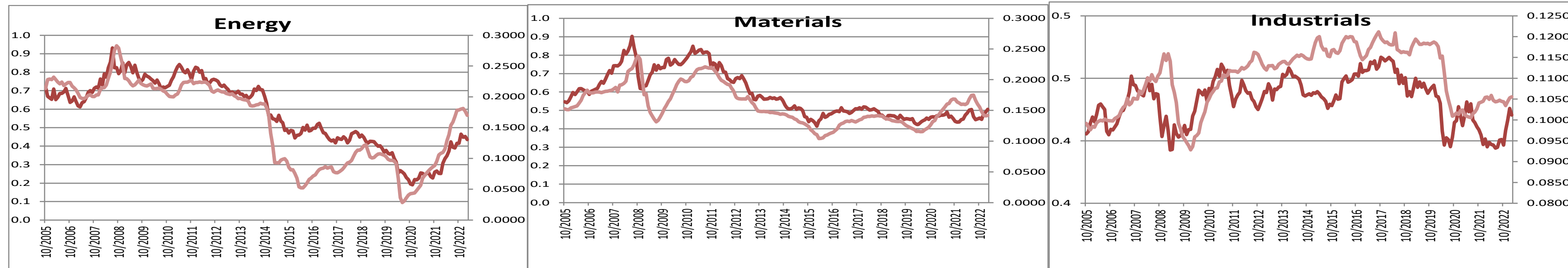
Profits have begun to factor in the weak growth ahead.

We are in a low return environment with costs rising, the bond hurdle is rising, the world has changed.

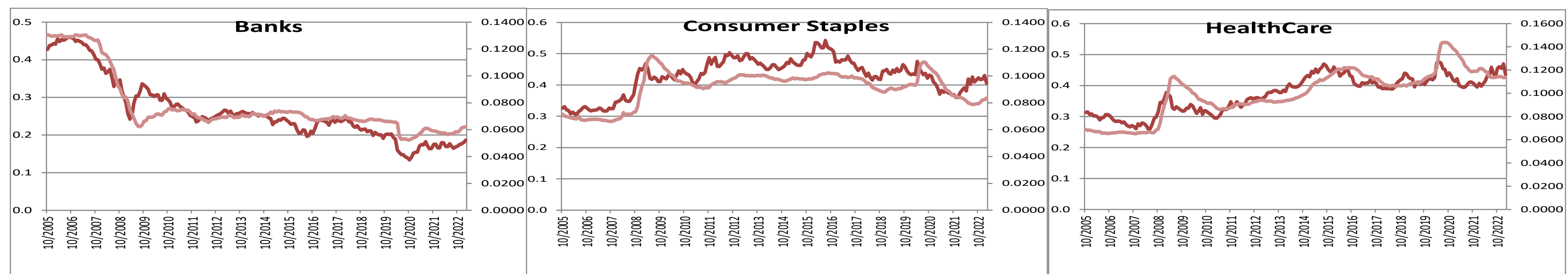
MSCI Equity Sectors Relative Performance and [E] Earnings (in USD)

Source: MSCI, Bloomberg,

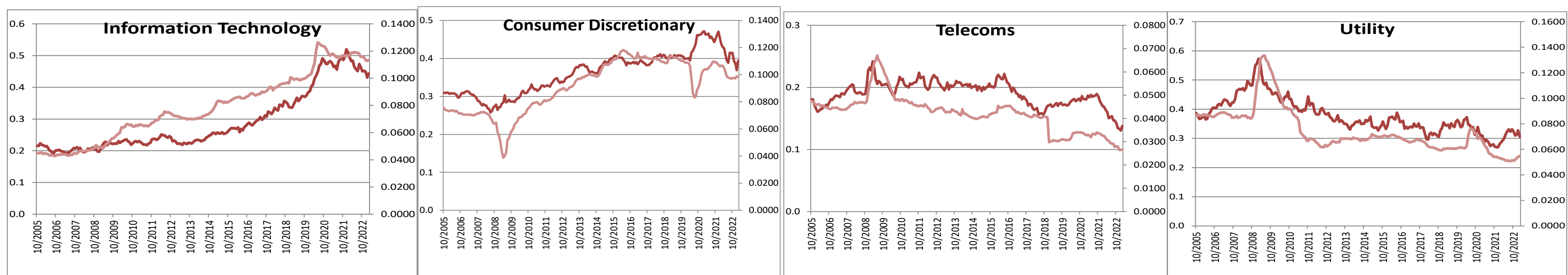
ECONOMI SENSITIVE LEADERS



EARNINGS BOTTOMING



EARNINGS DOWNTURN



PORT Factor Analysis

Source: Bloomberg,

Style	Factor/Driver Name (10)	1D Ret	1Wk	YTD	1Yr	10Yr
Volatility	PORT GL Volatility	0.28 %	1.67 %	7.12 %	2.59 %	7.65 %
Variability	PORT GL Earnings Variability	0.27 %	1.01 %	4.80 %	4.17 %	(16.91)%
Trade Activity	PORT GL Trade Activity	0.27 %	1.26 %	8.27 %	(2.39)%	(3.36)%
Leverage	PORT GL Leverage	0.15 %	(0.37)%	0.16 %	5.28 %	1.34 %
Size	PORT GL Size	0.10 %	(0.06)%	(1.19)%	10.77 %	15.08 %
Growth	PORT GL Growth	0.09 %	0.33 %	2.63 %	(6.88)%	(20.18)%
Value	PORT GL Value	0.05 %	(0.80)%	1.01 %	10.28 %	29.66 %
Dividends	PORT GL Dividend Yield	(0.10)%	(1.00)%	(2.68)%	8.84 %	22.05 %
Profitability	PORT GL Profit	(0.12)%	(0.60)%	(3.73)%	3.09 %	(5.11)%
Momentum	PORT GL Momentum	(0.19)%	(0.20)%	(8.15)%	1.12 %	1.72 %

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