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Equity strategy and market outlook

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Global perspectives: Absence of a negative

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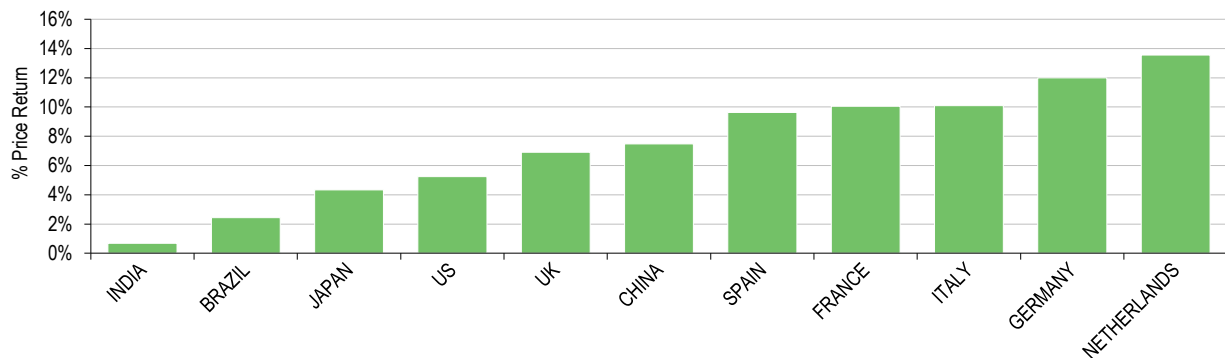
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- **There has been a remarkable rally in global equities during the first few weeks of 2023.** Cyclical sectors and markets have bounced back from the prior year's malaise. This is in line with [our thoughts](#) that all that was required to engender a recovery in investors' risk appetite was the absence of bad news.
- **Last year's downside risks, which hovered over markets, have to date failed to materialise.** Fortuitously, the mild winter weather in Europe has led to rapidly falling energy prices in the region. The war in Ukraine is ongoing but economies are adapting by diversifying food and energy supplies. Inflation appears to have peaked in Europe and the United States. As a result, interest rates have remained well behaved, even as consumer sentiment and growth prospects improve.
- **Over the past month, investors have had to reappraise China's prospects.** The abandonment of the zero-COVID policy is just one factor that is likely to result in a rebound in economic activity in China. A long period of regulatory intervention in the technology sector appears to have drawn to a close and press reports suggest China is shifting emphasis to resolving disputes with trading partners and away from unconditional ideological alliances.
- **Nevertheless, we believe investors who have benefited from 2023's 'January effect' should maintain discipline.** Global equity markets had just touched their long-term average price/book multiple before the rally but any further gains in the short term will once again leave valuations stretched.
- **Earnings estimates will be key to sustaining market momentum.** As markets have risen, global earnings forecasts have continued to fall broadly across sectors. In our view, for the rally to be sustained, earnings estimates will need to at least stabilise before the end of Q1.
- **Risks remain but in our view the recent rally is a logical consequence of the absence of bad news.** We remain positive on equities, with a focus on regions and sectors where valuations remain close to long-term averages, and we expect earnings forecasts to stabilise as companies start to outperform overly conservative expectations. Provided long-term interest rates remain stable, there may even be an increase in the volume of merger and acquisition activity from the highly depressed levels of 2022.

Absence of a negative

The first few weeks of 2023 have demonstrated that following a period of pessimism the mere absence of negative news can be sufficient to drive a powerful rally. Global equities have performed strongly year to date, especially where risks were perceived as highest. The outperformance of high 'beta' has been evident regionally and sectorally. European equities have led the market higher, while the largest global sector gains have been made in comparatively cyclical industries rather than defensives, which were 2022's outperformers, Exhibit 2.

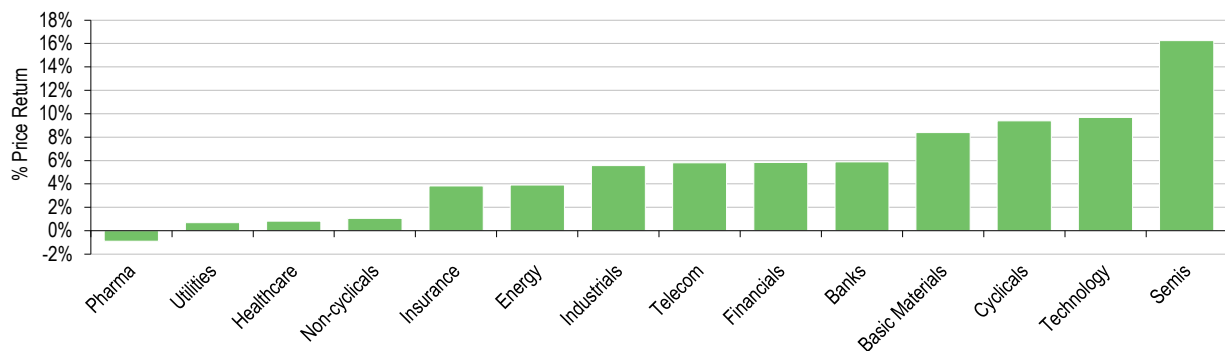
Exhibit 1: Stellar country returns led by 2022's European laggards



Source: Refinitiv, 31 December 2022 to 24 January 2023. Note: Returns shown in US dollars.

Key to this about-turn in market sentiment has been relative stability in long- and short-term interest rates. Global bond market investors have welcomed the recent peaks seen in US and European headline inflation rates. However, market-implied expectations that US rates could start to fall soon seem a little aggressive; we expect them to plateau before they start to fall slowly back to target. Nevertheless, recent data represent a welcome break from a 12-month period of ever-rising and above-consensus inflation readings.

Exhibit 2: 2023 year to date sector returns – fortune favours the cyclical



Source: Refinitiv, 31 December 2022 to 24 January 2023. Note: Returns shown in US dollars.

The much-feared winter squeeze on the European consumer has failed to materialise, even if this appears largely down to good fortune given record-high temperatures in the region during December. Prices for natural gas in Europe have dropped back to a fraction of the peak levels seen during the early autumn.

Weakening trends in commodity prices offer multiple benefits, including better European growth prospects in terms of consumer spending as food and energy prices fall, lower headline inflation and an improved fiscal position for governments forced to shield electorates from the short-term

economic impact of the war in Ukraine. Longer-term fiscal issues will need to be addressed but in the UK the sense of a fiscal and political crisis appears to have faded in recent months, with corresponding declines in the risk premium for sterling assets.

In some respects, 'Goldilocks' has made a tentative appearance as investors reappraise prospects for the evolution of the global economy in 2023. The calculus on the growth and inflation trade-off implied by recent market moves suggests investors are now downplaying stagflation fears. Instead, what appears to be gaining traction is a scenario of a relatively shallow slowdown before a non-inflationary re-acceleration in global growth as China picks up the slack later in 2023 following the removal of COVID-19 restrictions.

This may indeed be a fairy tale scenario, but it is not entirely unrealistic. The head of the International Monetary Fund recently indicated that global economic growth forecasts are likely to be revised higher from the current level of 2.7% as worst-case scenarios are avoided.

Investors have had to become accustomed to a heightened level of antagonism between China and the United States. This antagonism may have broken cover during the Trump trade wars, but it also reflects the United States' deep-seated concerns about China's rising geopolitical power.

However, 2023 has provided welcome relief as China's ['wolf warrior' diplomacy](#) has been rather abruptly cast aside, at least for now. Recent press reports indicate that China's administration has recognised that its interests are not best served by cutting itself off from Western markets, either politically through overt support for Russia, or economically by failing to engage with Western nations' concerns in respect of strategic rivalry, unfair competition and intellectual property.

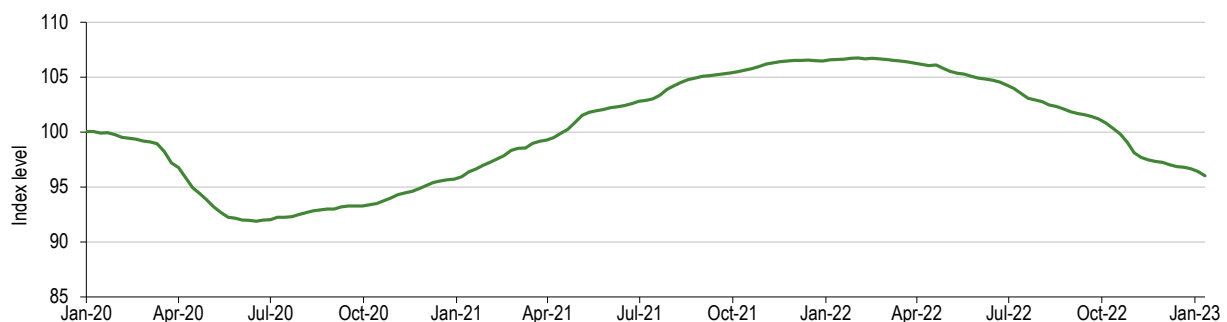
Furthermore, the effect that China's apparently arbitrary regulatory interventions have had on the growth of its most successful domestic technology companies now appears to have been recognised and this episode appears to have drawn to a close.

We view abandonment of the zero-COVID policy as an indication that economic growth in China has returned to the very top of the policy agenda and this is restoring confidence in China's markets. For example, from the low in November, and following a precipitous 18-month decline, Hong Kong's equity market has returned more than 40% in US dollar terms as sentiment has turned in the region.

Earnings estimates still on a downward track

Despite the optimism in global equity markets, which appears to a large degree attributable to the recent decline in inflation, earnings estimates for the year ahead continue to be revised lower, Exhibit 3.

Exhibit 3: Global earnings forecasts continue to be revised lower



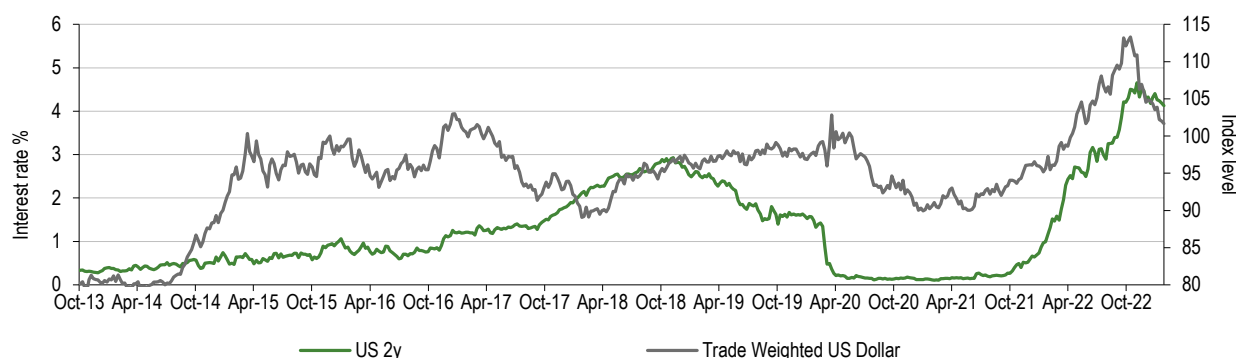
Source: Refinitiv, Edison calculations, equal-weighted global revisions index

This is not an immediate concern for us as it would be unrealistic to expect analysts' consensus forecasts for the corporate sector to so rapidly incorporate the recent improvement in expected growth prospects. However, we believe investors should be watching keenly for earnings upgrades and improving guidance, if the rally is to be sustained by improving company fundamentals.

Short-term rates stabilise and US dollar declines

We continue to believe the surging inflation/interest rate 'story' was largely a 2022 phenomenon. Inflation has peaked in the short term at least and in the coming months central bank policymakers are in our view likely to back away from overly hawkish commentary, particularly in the United States where policy rate expectations are close to 5%.

Exhibit 4: US two-year interest rates halt upward ascent and the US dollar turns sharply lower



Source: Refinitiv

The current inversion of the US yield curve, which often leads to the onset of a US recession, suggests the Federal Reserve's policy actions to date are likely to be successful in slowing economic activity. A critical factor in the recovery of investors' risk appetite globally is in our view the stabilisation of interest rate expectations with the US two-year rate now at 4.1%, well below the peak of 4.8% recorded in early November 2022.

During this period of declining US forward rate expectations, the trade-weighted value of the US dollar has fallen 10%, providing relief for lower income countries reliant on commodity prices denominated in dollars, and easing financial conditions on a global basis.

However, we expect inflation to remain well above US, UK and eurozone central banks' 2% targets during 2023 and investors hoping for rates to fall quickly may be disappointed. Instead, after completing the 'normalisation' process, we believe monetary policy is likely to be less exciting in 2023. In our view, interest rates may come to feel as if on a high plateau, with relatively little change during the year, even as inflation on both sides of the Atlantic slowly falls back to target.

Conclusion

The absence of negative news and the stabilisation of interest rate markets have led to a powerful rally in equities in the first few weeks of 2023. We believe the rally can be sustained provided earnings estimates also stabilise and company guidance starts to reflect improved growth prospects by the end of Q1. Nevertheless, investors should maintain discipline as global equity valuations, which had just touched long-term average levels, risk becoming extended once again unless corporate fundamentals improve. We believe market sentiment is unlikely to be retested in the very short term and maintain a positive view on equities, with a focus on regions and sectors where valuations are still in line with long-term average levels.

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