2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

JANUARY 2023

Editorial

We are finally coming to the end of this difficult year 2022, which will be remembered as one of the rare years when equities and government bonds experienced a double-digit decline. If we look at the history of the stock market for a century from the American angle, there have only been five years in which the S&P500 index and the 10-year US Treasuries have fallen simultaneously (1931, 1941, 1969 , 2018 and 2022). But 2022 is the only year in a hundred years where this joint decline has been greater than 10%. And the purge was severe in certain sectors, such as technology, for example. Thus, if the S&P500 fell by -19.44% this year, the Nasdaq100 for its part fell by -32.97%! Emerging stock markets were not outdone either with a decline of -22.37% for the MSCI Emerging Markets. Only Europe will have pulled out of the game with a drop of "only" 11.74%. The Bloomberg Global Aggregate Total Return global bond index for its part dropped by -16.25% due to the rise in long rates against a backdrop of rising inflation.

The invasion of Ukraine will undoubtedly have been the most significant event of year 2022. While according to American intelligence, a Russian incursion was possible a year ago, Vladimir Putin's decision to carry out large-scale operations well beyond the separatist region of Donbass has gripped the whole world in awe. In response to this, the economic sanctions imposed

Residential building in the suburbs of Kiev after a rocket attack on February 24, 2022 (Credit Image: © State Emergency Service Of Ukraine/Planet Pix via ZUMA Press Wire)

by the West came at a time when the supply of raw materials was often insufficient to meet the vigorous post-Covid global demand. Russia is a major producer and exporter of a large number of these raw materials, whether natural gas, oil, industrial metals or even certain agricultural raw materials. The global economy thus had to deal with a supply shock on several commodities, with a double consequence: lower growth and higher inflation. More broadly, a new global balance is being established. It must be realized that if Europe, the United States or even Australia have shown solidarity concerning these sanctions, more than 80% of the world's population do not apply them. And it is clear that relations between Russia, China and India have come out of it strengthened.

Inflation, which was already picking up in OECD countries in a context of post-pandemic global economic recovery, surprised on the upside throughout 2022. Thus, in Europe, inflation over 12 rolling months reached 11.5%, its highest level since the statistics have existed, i.e. 1963. Ditto in the United States which peaked at 9.1% last September compared to the previous year, following rising food, gasoline and housing prices, in a persistent context of wage pressures.

As a result, the US Federal Reserve had no choice but to raise interest rates for the first time since 2018. The assessment of the situation on the rising price front also changed compared to an initial position where Fed officials characterized inflationary pressures as transitory. The US monetary authorities thus raised the Fed Funds rate seven times, from 0.25% in March 2022 to 4.50% today. As for the size of the institution's balance sheet, it has been reduced by half a trillion dollars. In short, the end of easy money. 10-year interest rates reacted violently as a result, bounding from 1% at the start of 2022 to almost 4% at the end of December. This forced normalization will not have been without consequences on the equity markets, in particular on "growth" type stocks, with a high P/E and in particular on technology, with sometimes declines flirting with -50% on Amazon or Intel, for example.

In this still very uncertain context, what can we expect for 2023?

The good news is that a number of factors that weighed heavily on the downside in 2022 are either going to or starting to fade.

Thus, with the sharp economic slowdown underway in the United States, or even the recession taking hold in Europe, it is likely that we have passed the peak of inflation and that central banks have covered most of the path of the rise in short rates. Some observers even think that the Federal Reserve could start lowering its rates again at the end of 2023. Especially since in recent months, energy prices have begun to decline. Thus, the price of the 1-month gas contract in Europe fell from 311 on August 25th to 74 on December 30th. Similarly, the barrel of crude fell

	Q4 2022	FY 2022	Close 31/12/22
DOW JONES	15.39%	-8.78%	33 147.25
S&P 500	7.08%	-19.44%	3 839.50
NASDAQ 100	-0.29%	-32.97%	10 939.76
EUROST.50	14.33%	-11.74%	3 793.62
CAC 40	12.35%	-9.50%	6 473.76
FTSE MIB	14.81%	-13.31%	23 706.96
MSCI EM	9.20%	-22.37%	956.38
CRUDE OIL	0.97%	6.71%	80.26
GOLD	9.84%	-0.28%	1 824.02
EUR/USD			1.0705
EUR/CHF			0.9896
EUR/GBP			0.88534
EURIBOR 1M			1.884%

from $122 on June 8th to $80.49 at the end of the year.

The same observation goes for long term rates. Most of the rise in long yields is probably behind us. The increase from 1.50% at the start of 2022 to 4.30% on October 21st already includes a lot of things from an inflation point of view. Moreover, since that date, US long rates have resumed a downward trajectory, hovering around 3.70% at the time of writing. As an immediate consequence of this, a bond market, which after a catastrophic year 2022, could cease to be a burden for diversified portfolios, or even once again become a source of performance through the dual effect of the stabilization of either the fall in long-term rates or the reduction in credit spreads. In addition, an interesting corollary for the equity markets, actuarial rates that stop rising constitute one less negative factor for the stock markets, especially in sectors that are expensive in terms of P/E such as technology, which could make a comeback after the debacle of 2022.

Another source of potential good surprises: China. After a Zero-Covid policy which had a disastrous effect on activity, caused major disruptions in supply chains and triggered a major wave of protest, we are now witnessing the gradual end of restrictions. If Beijing continues on this path, Chinese growth could surprise on the upside, especially if the Chinese authorities become a little more pro-business again in terms of certain regulations such as those affecting the education, gaming or technology sectors in the broad sense. The Chinese stock market, after 2 years of marked decline, could therefore once again become a vector of performance for portfolios.

An additional important supporting factor is the energy transition, which the current conflict makes more inevitable than ever, especially in

terms of independence. Billions of public money will be poured into new ecosystems, into new value chains and this will create growth. We must nevertheless make the distinction between the European heaviness where money is trickling into companies compared to the Biden plan (Inflation Reduction Act), very pragmatic and consistent in its allocations. Thus, the IRA provides for 430 million dollars of investment, including 370 billion dedicated to reducing greenhouse gas emissions by 40% by 2030, i.e. the largest effort ever made by the United States in this domain. These investments will take the form of tax cuts for companies that invest in clean energy, as well as significant subsidies for electric vehicles, batteries and renewable energy projects when these products are manufactured in the United States. Among these measures, 7500 dollars will be granted to households for the purchase of an electric vehicle made in the USA (which incidentally greatly displeases the Europeans who threaten to go before the WTO for debate), another one favors manufacturers of wind turbines and solar panels using American steel or even a tax cut to help companies achieve their energy transition. In short, something concrete, generating a virtuous cycle of growth in many new segments that could partly mitigate the negative effects of the current economic slowdown across the Atlantic. Either way, and this is also a positive for 2023, it is worth remembering that historically bull markets are always born in times of recession.

However, there are still a number of risk factors to this scenario that 2PM will endeavor to monitor closely. *(continued on page 4)*

The Big Picture

India: The next China ?

The Indian equity market has recorded one of the best performances in Asia this year by managing to attract foreign capital, unlike China, which has lost many investors mainly due to the forced shutdown of its economy and its anti-Covid measures. Even the Indian stock market (with the Sensex index expressed in INR) reached its record with an increase of more than 8% at the end of November to end the year at +4% while all the major stock market indices ended in the red. The country is benefiting from new contracts, particularly from manufacturers in the tech field who are beginning to redirect their investments from China to India or, in any case, are studying the possibilities of diversifying their production outside of China: a major opportunity for India to capture new market share.

Overall, we have seen a return to emerging market attractiveness over the past few weeks, with Indian equities a key beneficiary. China no longer seems to be the sole driver of Asian growth as India takes over and demonstrates real resilience in the face of a slowing global economy.

Indian growth, estimated at 7% in 2022, will have been twice that of China and its development prospects are very positive. The country is characterized by a stable political framework, favorable demography with a population soon to exceed that of China, including a "reserve" of more than 300 million young consumers, mostly educated and solvent. This will allow the supply of labor to increase, a key factor in economic growth. However, the country faces challenges on social and governance aspects: a large majority of the population does not benefit from this growth, which is very unequally distributed, due to inequalities between the different castes.

Furthermore, on the stock market, even if risk appetite will continue to increase, it will be more difficult for the currently rather high valuations of Indian equities to further outperform other now oversold and undervalued emerging markets. These high valuations are explained by a historically low level of corporate earnings, which will have to show their resilience and deliver steady growth over the coming years. Their financial position is now much stronger than a few years ago thanks to the debt reduction cycle initiated in 2015.

Private investment has disappointed over the past decade but industrial utilization is picking up and accelerating credit growth suggests the investment cycle is about to turn. The State Bank of India recently upgraded its credit growth forecast announcing an investment stimulus. After numerous mergers and a long campaign to clean up their lending books, public banks have never been healthier and better positioned to meet funding demands in support of this investment recovery. Large private players are also seeing strong credit growth. The demand for capital to finance new investments is particularly robust among the sectors of heavy and digital infrastructures, but equally in the renewable energy sectors.

On this theme, India can become a credible alternative to China also with regard to the production of green energy. At the G20 meeting in Bali last November, Prime Minister Narenda Modi promised that India would generate half of its electricity from renewable sources by 2030, a first step towards its long-term goal of net zero carbon emissions by 2070.

India's energy transition relies heavily on a single source of renewable energy: the sun. And in this sense, India is trying to replicate China's efforts to increase its solar installations. The government, as part of the vast "Make In India" recovery plan aimed at stimulating domestic manufacturing production and consequently exports, is encouraging the development of a competitive domestic solar panel industry to promote the energy independence of the country. Currently most Indian solar parks buy panels from China, which currently dominates the manufacturing process. Through its campaign, the Indian government is helping to increase manufacturing capacity, allowing domestic companies to capture market share.

On the inflation side, India was less affected by the explosion in energy prices, in particular because it decided not to sanction Russia following the conflict in Ukraine and, on the contrary, has become one of its main trading partners with oil imports of around 1 million barrels/day. Inflation rose in the first half to almost 8%, before stabilizing and showing the first signs of a slowdown (5.9% in December), thanks to the recent drop in commodity prices. Messages from the Reserve Bank of India regarding the duration of its monetary tightening are still mixed, which will keep bond yields rather volatile.

In summary, while we have seen some false starts over the past decade, today the essentials seem to be in place for a sustainable growth cycle in India. The country, the first democracy in the world, and according to forecasts the third largest world economy from 2027, largely underrepresented in the emerging stock market indices (only 11% whereas in terms of GDP it weighs at 45%), constitutes in several points a very attractive investment alternative for those targeting an emerging giant with great potential.

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Macro-economy

Inflation: Is the peak behind us ?

US:

- **The inflation rate continued to decline over the last months of the year; -2% compared to the June peak at +7.1%. Excluding cycli-cal effects, prices seem to be stabilizing around 6%.**
- **The decline in energy prices for several months is good news, especially the price of gas, which is back to its levels at the begin ning of the year. This should restore purchasing power and confidence to households.**
- **Indicators in the real estate sector are at low levels, it is the sector which has historically suffered the most from an increase in interest rates.**
- **The labor market is still quite dynamic; the structural lack of labor in certain sectors could partly offset the layoffs to come.**
- **The drop in the manufacturing activity indicator to 48.4 and the surprise drop in services activity to 49.6 (perhaps with an impact due to the bad weather in December) testify to the effectiveness of the Federal Reserve's monetary policy.**

Euro Zone:

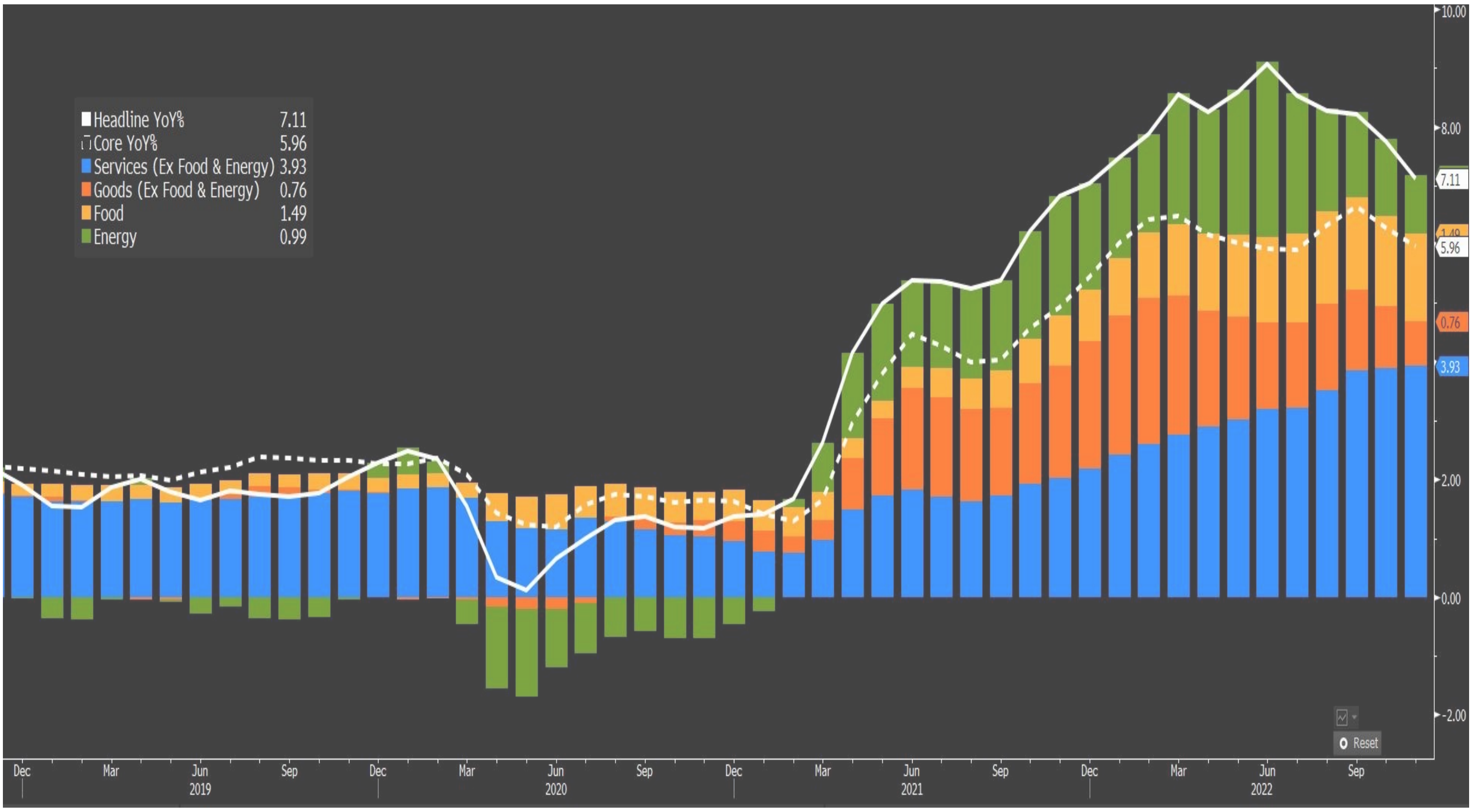
- **In 2022, the impact of the energy crisis is responsible for more than half of the price increase.**
- **This is good news at the end of the year, with the disinflation that seems to be starting; the increase in prices in Germany came out in December at +8.6% and in France at +6.7%; at -2% and -0.4% respectively from the highs.**
- **This shows inflation for the Euro Zone which reached +10.6% in October, before falling back to +10% the following month and +9.2% in December.**
- **The PMIs for the manufacturing and services sectors (47.8 and 49.8 respectively) attest to an ongoing recession. Quarterly results and company expectations for 2023 will help us better appreciate the impact this reflects.**

China:

- **The Chinese macroeconomic environment is different with an expansionary monetary policy to support activity.**
- **2022 will have been another COVID year with a number of restrictions and lockdowns which have greatly disrupted the economy.**
- **At the end of the XXth Congress of the Communist Party, the authorities decided to help the real estate sector more significantly and, under pressure from the masses, abandoned the Zero Covid policy.**
- **The next few weeks could be chaotic but growth should rebound in 2023 and be stronger than that of the G7 countries.**

Damien Liegeois

US CPI Index YoY (*) since 2019



Special Topic

Post-Congress China: Power Consolidation and Pragmatism.

Even if we felt it coming, at the end of the 20th Congress of the Chinese Communist Party, Xi Jinping was still surprised as he tightened his grip on the country. His name is now inscribed in the constitution, he will serve a 3rd term (he has thus set aside the unwritten rule of stopping at two with an age limit of 68), and the new political office is composed of only loyal and close allies.

It was no longer an election within the party but a real appointment; Xi Jinping now commands full power. Unprecedented since a long time for a Chinese leader.

In the aftermath of these announcements, the financial markets took the conclusions of the congress rather badly, taking a dim view of this concentration of power, moreover, without major economic announcements, in particular on the reopening of the economy.

The first good surprise came quite quickly in mid-November with the meeting between the Chinese president and his American counterpart. On the occasion of the G20 summit, the two leaders, having consolidated their respective powers, had a long meeting of 3h30 aimed at reducing the risk of misunderstandings and poor communications on sensitive subjects. The

idea was to reduce the pressure with the acceptance of differences and mutual red lines, especially on the Taiwanese file. Above all, the two powers agreed to prevent competition from becoming confrontational. The road is still long, but the mutual resolve is rather to de-escalate.

On the economic front, the Chinese authorities have also demonstrated pragmatism and rapid action. Popular protests, which erupted in several places against COVID restrictions, led to the Chinese president hastily abandoning his Zero Covid policy and accelerating the reopening of the economy. "Living with Covid" is now the rule, which leads to an explosion of cases (and deaths), to massive vaccination of the older and fragile populations, but will allow a powerful rebound in consumption.

Another thorn in the side of Chinese leaders, the real estate sector, now “cured” of its excesses, it will be supported by a recovery plan, particularly for developers; assistance with debt repayment, new bank loans, possibility of making capital increases, government guarantees… 16 very specific announcements to restore public confidence in real estate investment.

Thus, after a rather cold reception from the markets on the political changes, investors welcomed this proof of pragmatism with regard to the two main brakes on the Chinese economy, which leads us to believe that the year of the Rabbit could be better than that of the Tiger.

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(continued from page 2)

- First, inflation. While it is likely that we have passed the peak as already mentioned, there is still uncertainty related to the final figure. Will the slowdown be such that we will quickly see 2-3% inflation again? In which case the Federal Reserve will restart a cycle of lower rates, which will please the equity markets. Or should we, on the contrary, expect the persistence of high prices, with inflation remaining around 4-5% year-on-year? In this case, the risk is clearly that the Fed, not wanting to fall back into the specter of the uncontrolled inflation of the 1970s, will delay its monetary easing longer than expected, or even make the mistake of remaining restrictive for too long. This would obviously be badly perceived by the equity markets and could lead to substantial stock market declines.

- Another point to monitor is the real estate risk in certain countries. Monetary tightening hits hardest the segments most sensitive to interest rates. Countries like Sweden with a high percentage of variable mortgage rates could experience a significant decline in house prices, which could prove problematic if the magnitude is too large.

- In Europe, many artisans or small SMEs are close to filing for bankruptcy. If the coming recession were too severe and many went out of business, the social breakdown that would ensue would undoubtedly be harmful to purchasing power, confidence and thereby, to growth.

- We will also closely monitor companies' earnings releases and their guidance for 2023. Earnings per share were generally resilient last year despite global uncertainty. But with recession looming, pressures on margins are real and likely weakening consumer demand. A sharp drop in profits cannot therefore be ruled out, at least in certain sectors. Is this fully integrated by the current level of equity markets? It’s hard to say at the moment.

- Finally, we will be particularly attentive to new developments in the Ukrainian crisis. At this stage of the conflict, it seems clear that Moscow is preparing a large-scale operation. And the respective wishes of Messrs. Putin and Zelensky leave no room at the moment for any hope of a possible ceasefire. Everyone talks of victory and the Western camp is supplying increasingly sophisticated weapons to the government in Kiev. When will the Russian president consider that Europe or the United States are de facto co-belligerents? Is there a risk today of the conflict spreading to other countries? These are obviously points to watch very closely, as they are a potential source of volatility.

After the 2022 meltdown, equity markets are not overvalued and are trading at their long-term historical average. We’re betting that the good surprises will outweigh the bad.

The entire 2PM team wishes you all the best for this new year.

Christophe Carrafang