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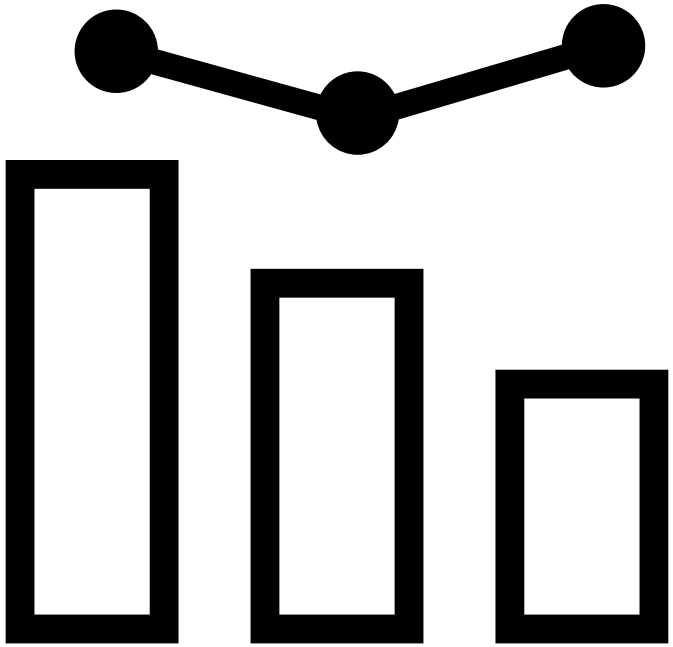

Market update

14 november 2022

October 2022: 'Oktoberfest' in the financial markets?

The financial markets recorded excellent performance in the month under review. You could almost call it 'Oktoberfest' in the financial markets, were it not for the fact that there is little to celebrate in today's macro and geopolitical environment. Nevertheless, developed market equities added 6% in October, with North America (7%) slightly outperforming Europe (6%).

There are no obvious reasons for these impressive equity market gains. Perhaps investors foresee a minor slackening of central banks' strong pace on rate rises. In addition, the figures reported to date by some listed companies overshot expectations. Another contributing factor may have been the smoother sailing for UK politics with the appointment of Rishi Sunak as the UK's new Prime Minister – who is also the UK's first Prime Minister of South East Asian descent.

Asian and emerging markets did not share in the October joy and were the only two asset classes posting a decline. The main driver of this trend was China, where equity markets fell following Xi Jinping's third-time election as party leader of China's Communist Party in an apparent move to solidify his power.

In line with equities, listed property did not do so badly either (5%), but nevertheless showed the worst FY2022 performance by far (41%). Government bonds recorded a modest plus (0.2%), despite the minor increase in long-term rates in the eurozone in October. Gaining 1.8%, high yield corporate bonds benefited from positive equity market sentiment.

The returns on the various asset classes were as follows:

Returns (total return, in euros)	Oct.	Q4	2022	12 mos.
Bloomberg Barclays Eurozone Staatsobligaties	0.2%	0.2%	-16.5%	-16.4%
Bloomberg Barclays Euro Bedrijfsobligaties	0.1%	0.1%	-14.5%	-14.4%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	1.8%	1.8%	-13.2%	-12.9%
MSCI Europe Onroerend Goed	5.1%	5.1%	-41.1%	-40.6%
MSCI Europe Aandelen	6.2%	6.2%	-12.2%	-9.7%
MSCI North America Aandelen	7.0%	7.0%	-6.7%	-2.6%
MSCI Asia Pacific Aandelen	-2.7%	-2.7%	-17.0%	-17.2%
MSCI World Developed Markets Aandelen	6.2%	6.2%	-9.3%	-6.1%
MSCI Emerging Markets Aandelen	-3.9%	-3.9%	-18.8%	-19.3%
EUR/USD	0.8%	0.8%	-13.1%	-14.5%

Source: Bloomberg

Economic growth is positive (for now)

Although still positive, economic growth is clearly slowing in the eurozone. Year-on-year (YOY) GDP growth stood at 2.1% in the third quarter, half the 4.3% growth posted in the second quarter. But forward-looking indicators paint a gloomier picture. Consumer confidence, for example, is at a 40-year low (27.6), in part because high inflation is eroding consumers' purchasing power.

The US is actually not doing all that bad in terms of economic activity. In fact, the US economy seems to be recovering somewhat from the 'technical recession' it suffered in the first half of the year, when the economy contracted for two consecutive quarters. In the third quarter, the US economy grew by 2.6% quarter-on-quarter (seasonally adjusted and converted to an annual growth rate). That is above the 20 year average of 2.1%. The relative strength of the US economy is also reflected in the jobs market. Unemployment is at a historic low of 3.5%, the number of vacancies is almost double the number of jobseekers and at 6.3% wage growth is also at a historic high. Going forward, this data indicates that the US central bank will probably not end its policy rate hikes any time soon.

Overall, neither the eurozone nor the US has good economic prospects. In both regions, higher policy interest rates will slow the economy, with high energy prices, uncertainty regarding the war in Ukraine and wages lagging behind inflation also playing a role in the eurozone. That difference is reflected for example in the Bloomberg consensus estimates on economic growth, which are lower for the eurozone (0.1%) than for the US (0.4%) for 2023.

Inflation: persistently high

Inflation is still persistently high in many countries. Surprisingly, inflation keeps surprising economists' consensus estimates. In the eurozone, for example, YOY inflation was 10.7% in September, whereas estimates were more in the range of 10%. Further, eurozone core inflation has risen to 5% YOY, indicating that products and services other than energy and food are also becoming increasingly expensive. The US does show some tentative signs of cooling inflation. September inflation in the US stopped at 8.2% YOY, flat on the previous month. Core inflation, too – the Fed's measure of preference (the 'PCE deflator') – stopped at 6.2% YOY, flat on the previous month.

That said, however, core inflation is still well above the 2% target of the US and eurozone central banks, and in the US wage growth is also still high. Not surprisingly, therefore, Fed chairman Jerome Powell, in addition to announcing a 0.75% rate hike, indicated in his latest speech that the bank would continue raising rates for now. The ECB will follow the Fed's lead in the short term. However, that does not mean that the Fed and ECB have the same policy rate peaks in mind, or that they will keep policy rates at their respective peak levels for the same length of time.

China: Xi is solidifying his power and self-sufficiency is still a hot topic

The 20th Party Congress of the Communist Party took place in China in October. During the congress the country's long-term policy was presented and Xi Jinping was elected General Secretary of the Communist Party – and the country's de facto leader – for the third time.

Asian financial markets' response to the news was extremely negative. Between the announcement of Xi's re election and the end of the month, the Shanghai Shenzhen index lost over 6% and the Hang Seng index lost over 9%. The decline stems not so much from Xi Jinping's re election (which had been expected since last year) but rather from his solidifying his power, as for example shown by his replacement of several members of China's main political body (the Standing Committee of the Communist Party of China (CPC)) by like-minded people.

In addition, Xi Jinping's speech at the congress indicates that China intends to take an even less market-minded and more protectionist road. Several times Xi Jinping used the words 'common prosperity', which may deter major entrepreneurs in China for implying a preference for wealth distribution over entrepreneurship. China's zero-Covid policy was also cited as a victory, suggesting it will not be abandoned any time soon.

Further, Xi Jinping's speech showed that in China's eyes the world around it is growing more hostile and uncertain, which calls for greater self-sufficiency. This self-sufficiency has become an increasingly important issue for China in recent years. The country wants to be less dependent on other countries for economic growth, trade and knowledge and technology, among other things. In other words, China is willing to give up economic growth in favour of resilience.

China's long-term policy has a number of implications. First, China may very well grow much more slowly in future than it has done in the past. Whereas China's main focus used to be on growing its economy, its focus will shift a bit more to wealth distribution. There are more important developments underlying the imminent economic slowdown, such as the accelerating ageing of the population and, in the shorter term, property market cooling. But the new long-term policy seems less focused on growth than in previous years. That will have implications for the global economy as China drove (roughly) one third of global economic growth in the last twenty years.

Second, it does not seem likely that China will become any less assertive on the world stage, for example with respect to the South China Sea and Taiwan. China-US relations also seem more likely to deteriorate than improve. One of the dimensions where China wants to be less dependent on the rest of the world is the production of advanced computer chips. That is exactly what the US tries to prevent, as this could pose a threat to its technological hegemony. With that in mind, tensions around Taiwan (where TSMC, manufacturer of one of the most advanced computer chips, is headquartered) will become more of an issue.

Finally, it seems safe to assume that the government will play an even bigger role in China's economy, which will affect both domestic and foreign companies operating in China. This may prompt foreign companies currently manufacturing in China to move some of their production facilities to other countries in Asia (to Vietnam and India, for example).

In the short term, however, the world cannot ignore China. Many international value chains still pass through China, the country is a global leader in several products (ranging from rare metals used in electronics to batteries for electric cars) and it is a large market for many international companies. However, for long-term investments in China, policy uncertainty has increased.

Tactical opportunities?

Next year looks far from great in terms of economic growth and inflation. A recession seems very likely in the eurozone and certainly a possibility in the US, and the likelihood that China will underpin global economic growth as it used to do in the past is small. Add to that worldwide monetary tightening, higher geopolitical uncertainty and a decline in real purchasing power and the outcome is not exactly positive.

Still, there may be opportunities from a shorter-term (tactical) perspective, as most asset classes shed much of their value this year – even though much of the economic woes comes from equities and sentiment seems to be turning in the short run. Between the relatively safe asset classes – such as bonds – and relatively risky categories – such as equities and property – bonds (especially government bonds) seem somewhat less interesting, in view of the rate hikes and persistent inflation on the horizon. Between equities and listed property, property seems slightly more attractive as it has by far declined the most this year (and therefore looks less expensive), while protecting against inflation relatively well. We therefore have a slight preference for listed property in the short term. We are a little less keen on government bonds and we are neutral on equities, cash and corporate bonds.

That said, we are less vocal than average about this tactical view, due to the major uncertainty reigning in the financial markets. While October was a festive month for returns, past experience tells us that a great party might well be followed by a massive hangover...

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