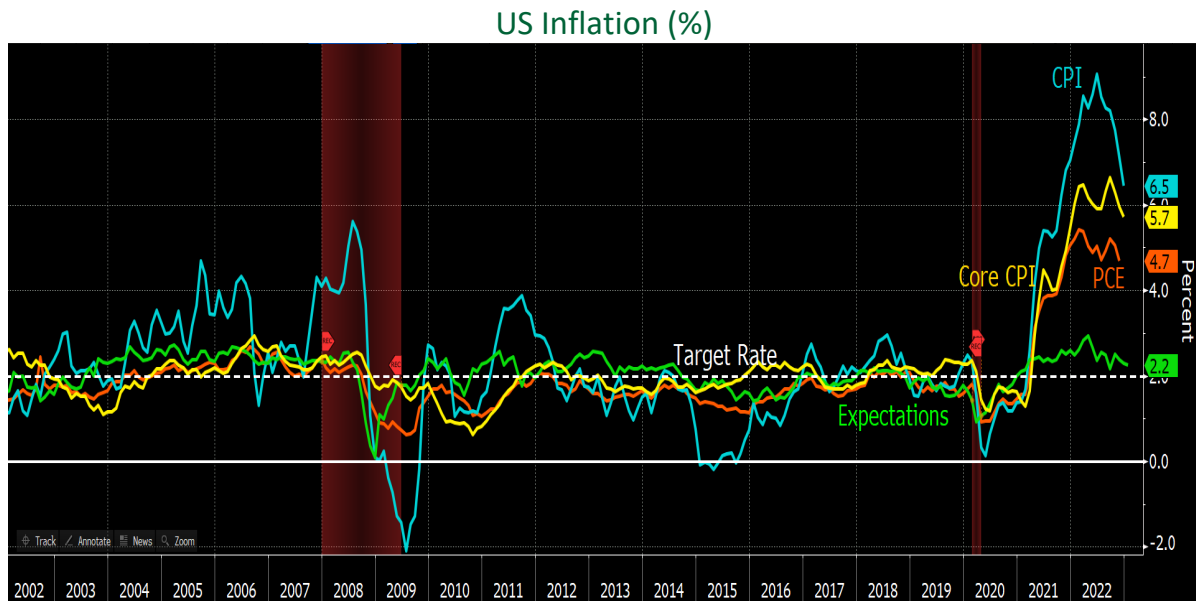


“Every science begins as philosophy and ends as art.”

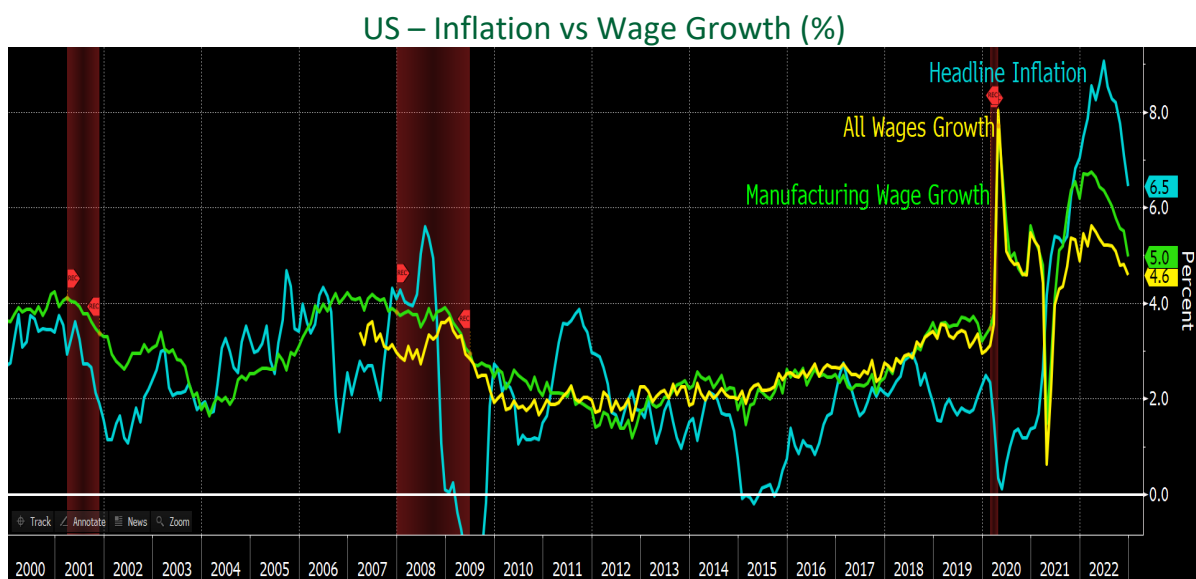
Will Durant

1. US INFLATION

The dominant macro capital risk factor of 2022 clearly was inflation. It seems 2023 is starting on a better footing in this context:



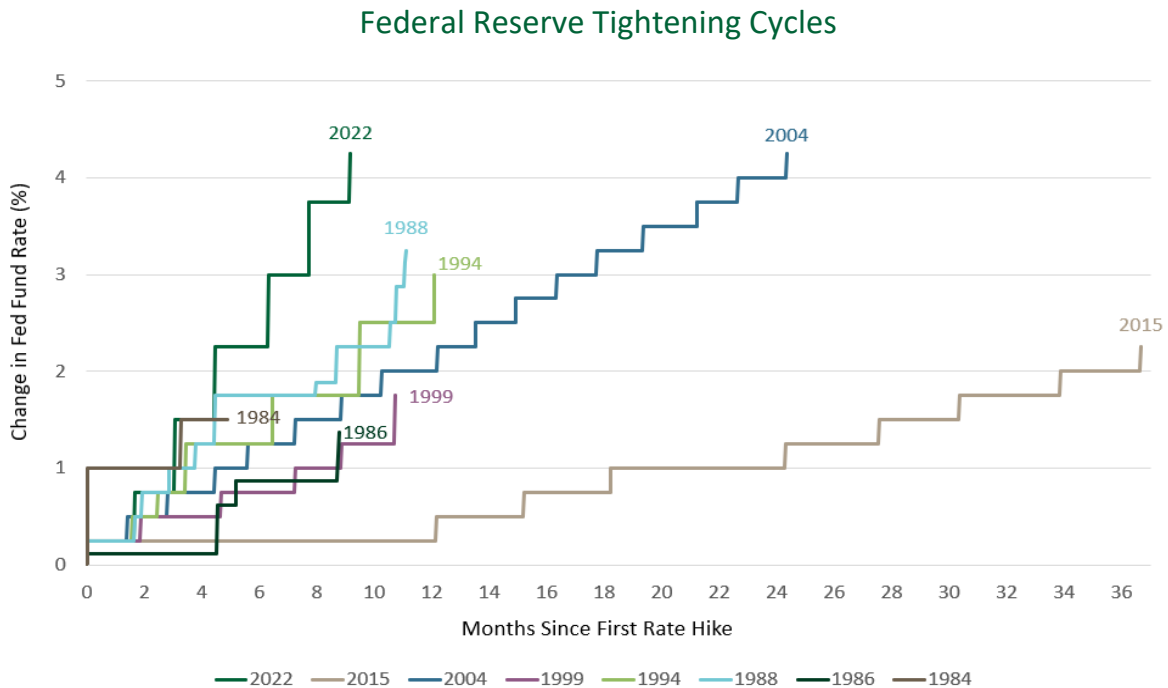
All of Headline CPI (Consumer Price Index), Core, PCE (Personal Consumption Expenditure) and implied long term inflation expectation metrics are currently trending downwards. Despite being in mid-winter, energy costs have surprise to the downside. Cost of rented accommodation remains a challenge and many (including the Federal Reserve, or Fed) fear the stubbornly low unemployment ratio in this context.



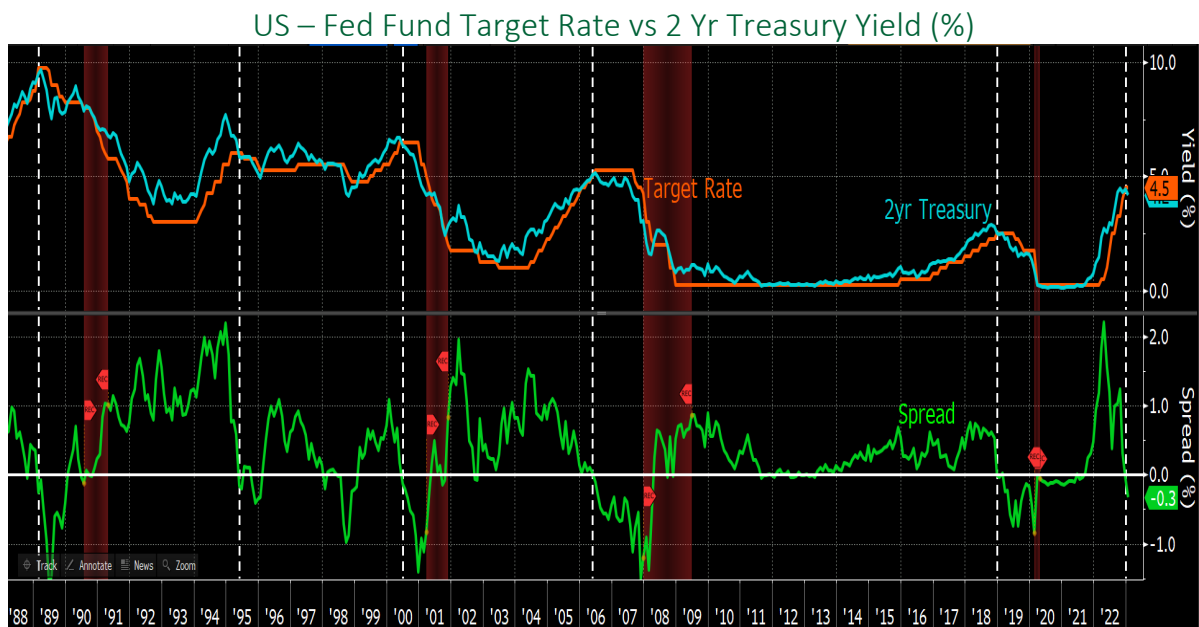
Both Manufacturing and All Employee wage growth levels are also in a downward trend. Whilst wages are a huge issue in the inflation context, with slowly lower job opening numbers and more layoffs, it seems the inflation threat from this corner is also receding. It appears the inflation threat of 2022 is turning to a supportive for capital market sentiment in 2023.

2. THE FED'S TASK

The Fed has a huge task to dampen inflation whilst not damaging the economy too much. Their skills were (and currently are) being put to the test.



The above chart reflects the Fed's historic target rate hikes and the periods over which it was done. Clearly the current rate hike cycle is by far the most aggressive hiking cycle – the total of 4.25% of hikes thus far has only been matched once (and it may soon become the record level of hikes since 1980), and it has happened over only ten months, against 25 months for the comparable 2004 hiking cycle. This aggression took a severe toll on the capital markets in 2022.



The above chart has an important message and deserves thorough consideration. It shows the Fed Fund target rate, the two-year Treasury yield, and the spread between the two (the green line). Its message is the Fed has historically taken serious consideration of the Treasury yield, and stopped tightening when its target rate exceeds the latter (the vertical broken lines indicate the triggers). This trigger has happened recently. On this basis, therefore, we believe the Fed's current task is getting close to being done. We would not expect an immediate halt, but do expect smaller further hikes (+0.25%). It seems investors can start looking forward to a more stable capital market environment.

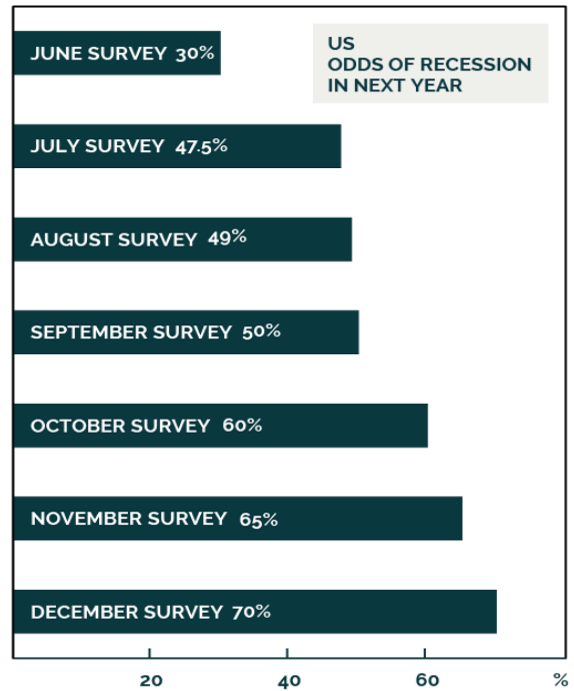


3. COMPANY EARNINGS

The US 4Q2022 reporting season is already in process – a tenth of the S&P 500 constituents have reported. Investor expectations are well dampened – whilst these companies have collectively delivered a -4% earnings result, this was +4% better than expected. Share prices have been relatively firm thus far.

This chart reflects economists’ opinions from Bloomberg polls. Expectations are running high for a potential recession, to the extent that, should a recession materialise, it will be the most anticipated one on record. For a number of reasons (e.g. weaker Dollar, lower energy costs, China reopening) we believe it may be a relatively mild recession and the potential drop in earnings may be relatively mild too.

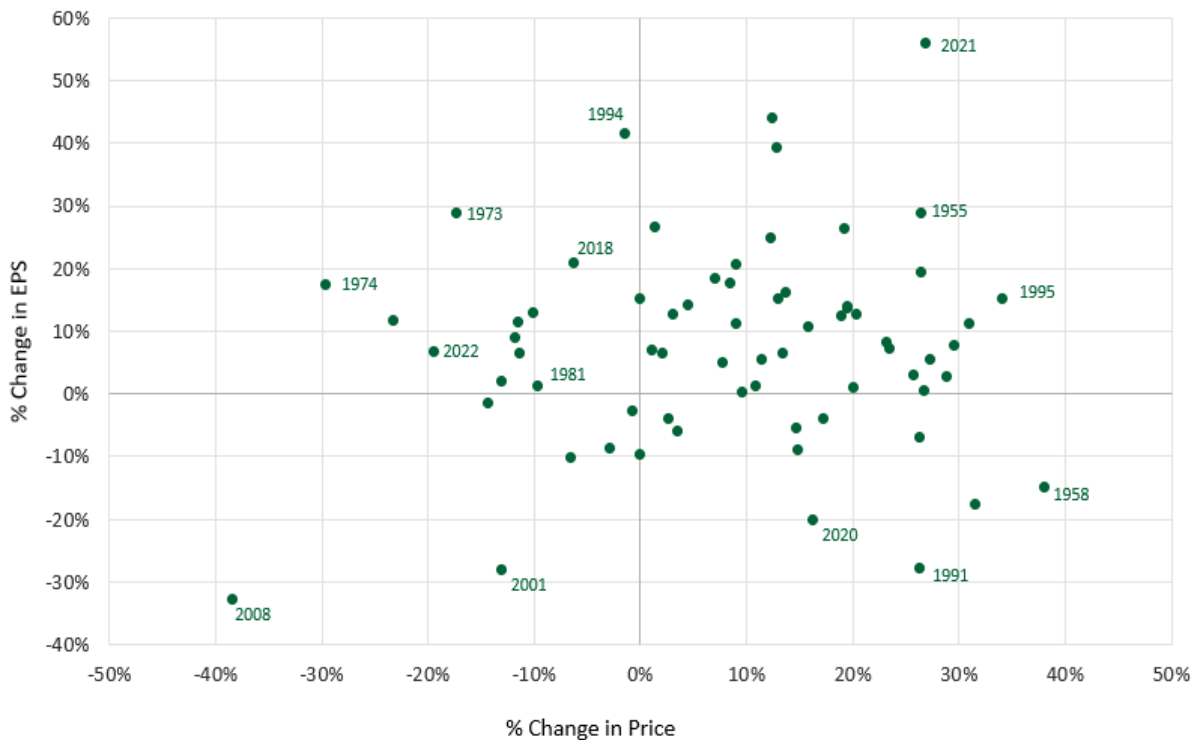
Whilst share prices follow earnings over time, it is not a linear correlation. Investor expectations and sentiment play a major role in this context. The following chart of data since 1955 makes this clear:



SOURCE: BLOOMBERG FINANCE L.P.

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S&P 500 Calendar Year Performance (Growth %)



Logically, the highest number of readings (56%) in the table is in the second quadrant with a linear correlation between earnings and prices. Interestingly, the second highest reading (19%) is in the first quadrant with positive earnings but negative prices. The next highest reading (15%) is in the third quadrant with negative earnings but positive prices. Strikingly, the lowest reading (10%) is in the fourth quadrant with both negative earnings and prices.

	Quadrant 1	Quadrant 2	Quadrant 3	Quadrant 4
Data Points in Each Qaudrant	13	38	10	7
% in Each Quadrant	19%	56%	15%	10%

Quadrants are numbered clockwise, starting in the top left

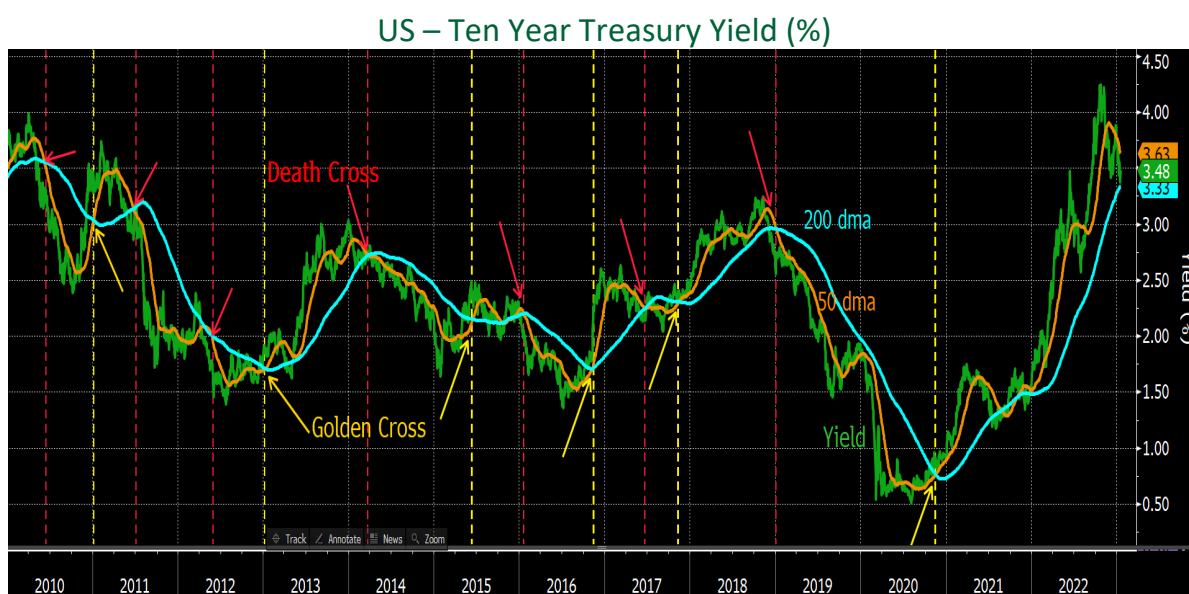


Chances are that many investors currently think in terms of the fourth quadrant and fear potentially negative stock market performance because of the risk of potential earnings contraction this year. According to the preceding data, there is a 50% higher probability of positive stock market performance despite potential earnings contraction.

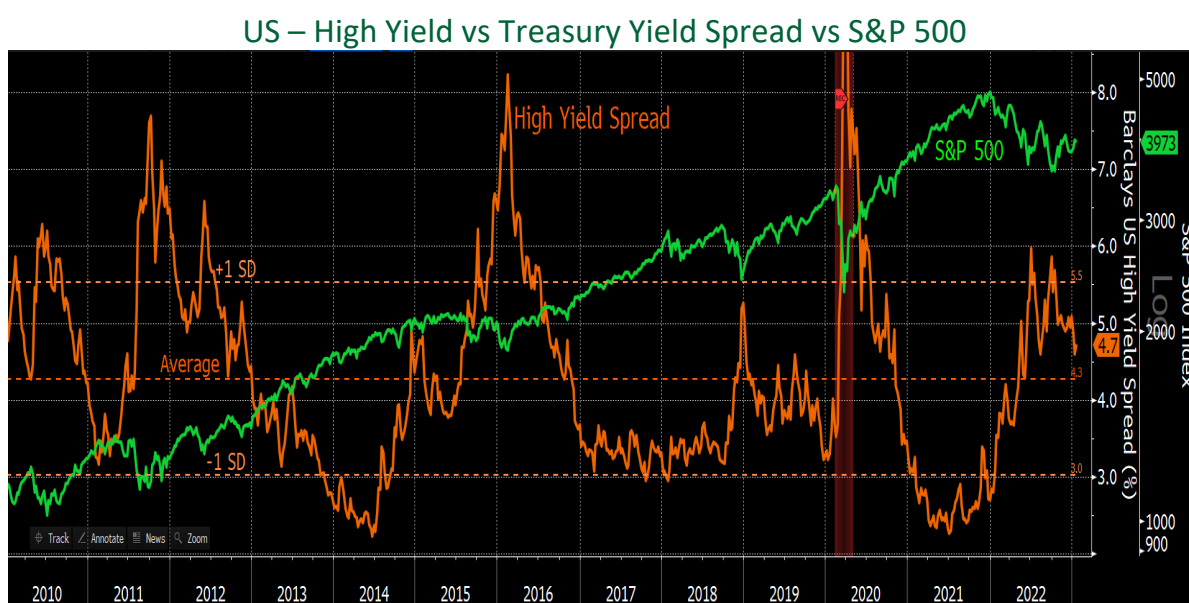
Logically, the stock market discounts future earnings, not current earnings. Investors have to orientate their thinking beyond the immediate earnings outlook and rather consider the quality and valuation of their business for future performance.

4. BOND MARKET

As the world’s most liquid market, we respect the US Treasury market for the signals it provides.



Following a turbulent 2022, the US bond market is currently relatively calm, with the yield in a downward trajectory and close to its 200-day moving average. Whilst it may reflect a weak US economic outlook, it also indicates that inflation fears are receding.



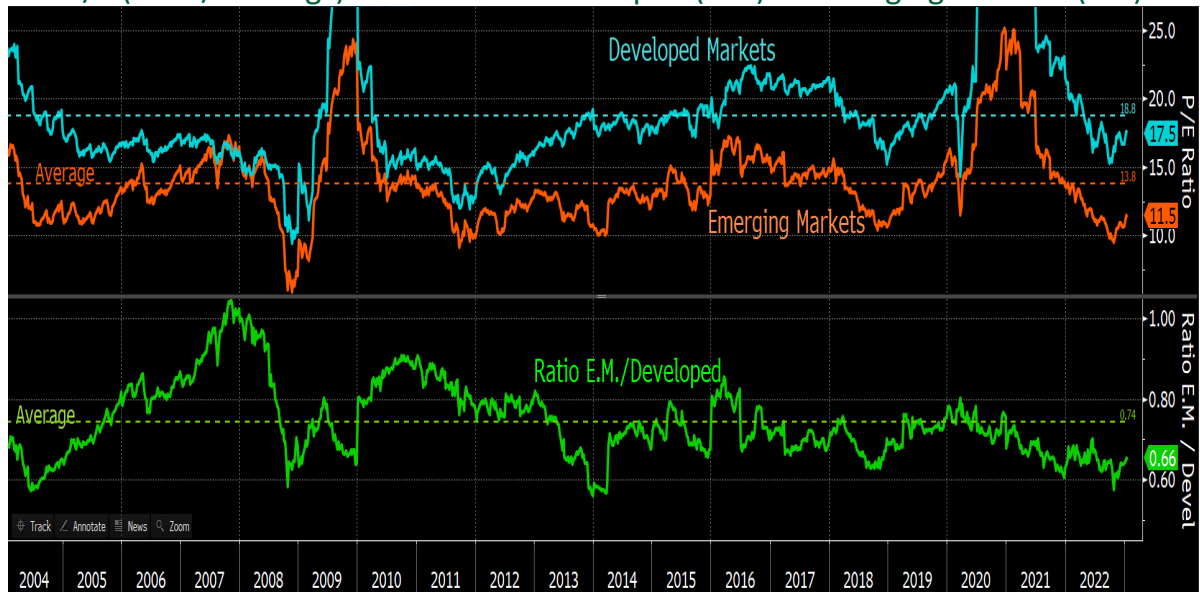
The sensitive high yield spread is drifting lower, and is close to its long-term average. This is another indication of calmness returning to the capital markets and its current trend is supportive of equities.



5. EMERGING VALUATIONS

Emerging market shares benefit from the weaker Dollar.

P/E (Price/Earnings) Valuations – Developed (DM) vs Emerging Markets (EM)



The current EM P/E valuation has recently turned from close to a record low level, both in absolute terms and relative to the DM P/E ratio. There is clearly good value in EM's. The challenge is to build comfort with risk premiums in some of the candidate countries. We can, nevertheless, expect some tactical investing in this regard.

6. TECHNICAL PICTURE

We consider the main technical indicators to understand how the market starts the new year:

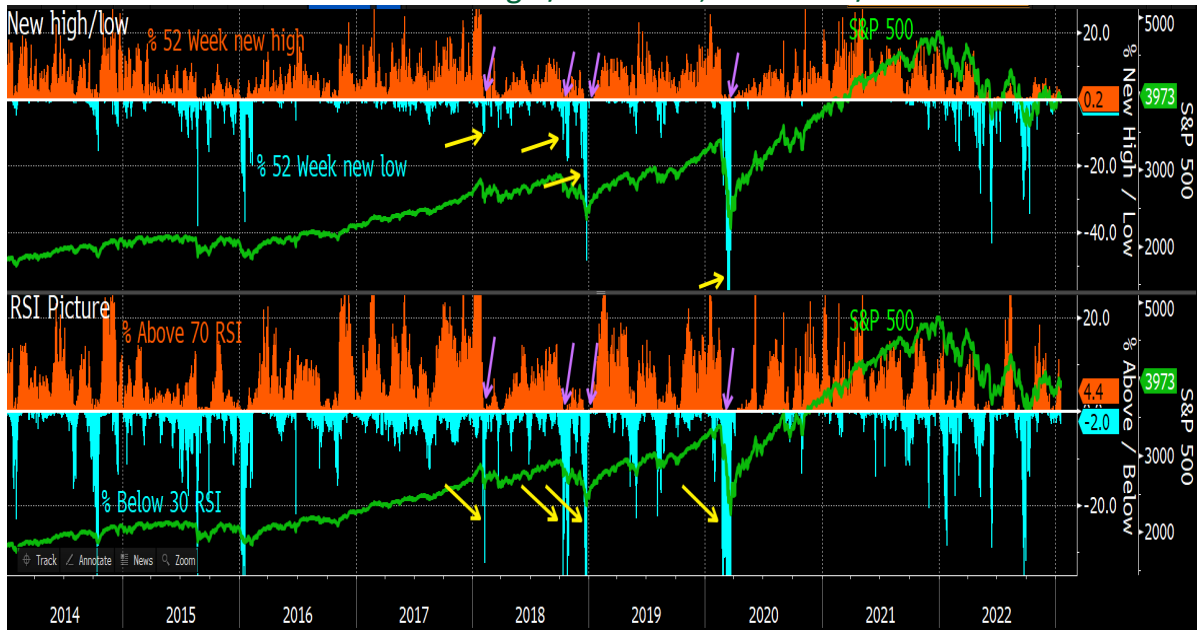
S&P 500 vs 50- and 200-day Moving Average



The S&P 500 index is finely poised with its 50- and 200-day moving averages a few points apart. A break to the positive can bed down the negative 2022 experience, with the opposite still not out of the question.

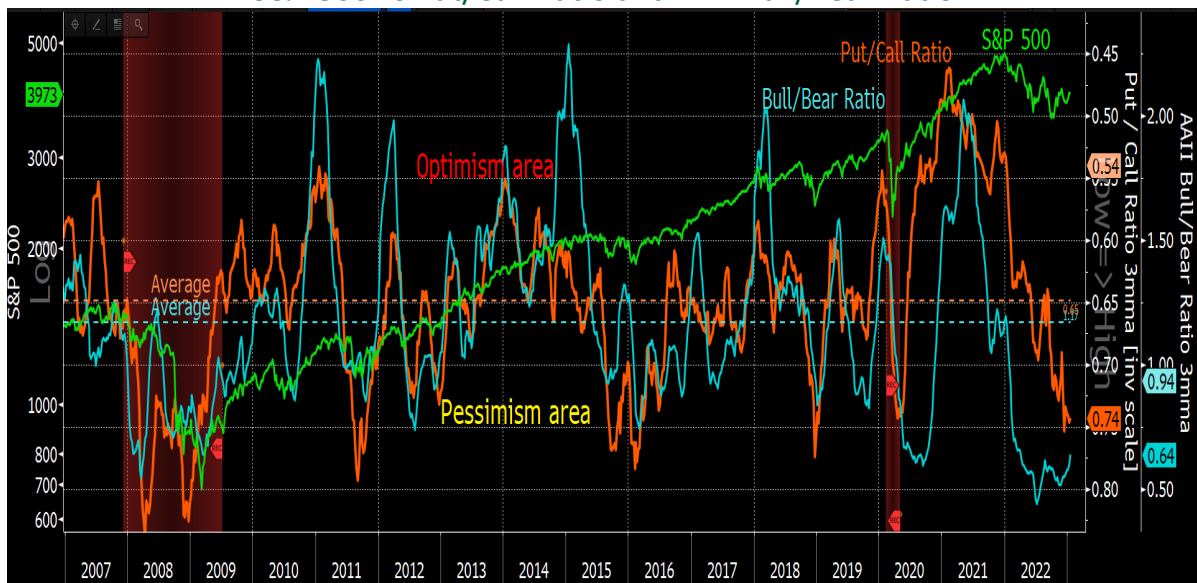


S&P 500 - % of Shares at New High / New Low, Above 70 / Below 30 RSI Levels



All the New High, New Low, 70 and 30 RSI technical indicators reflect limited percentages of shares in any of these categories. This also reflects a finely tuned stock market.

S&P 500 vs Put/Call Ratio and AAll Bull/Bear Ratio



The low level of optimism in both the institutional (Put/Call ratio) and the individual (AAll Bull/Bear ratio) is quite a feature. Both series are close to extreme levels. The illustrated series reflect short-term moving averages and show signs of stabilizing. The current single readings reflect positive changes and therefore, for us, tip the overall technical conclusion for us into a glass-half-full argument.

Gerrit Smit

**Partner - Head of Equity Management
Stonehage Fleming Investment Management Limited**

6 St James's Square
London
SW1Y 4JU

T +44 20 7087 0000
Email gerrit.smit@stonehagefleming.com
www.stonehagefleming.com/gbi



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