GLOBAL MARKET REVIEW & OUTLOOK

30 January 2023

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YOUR PARTNER IN FINANCIAL SERVICES

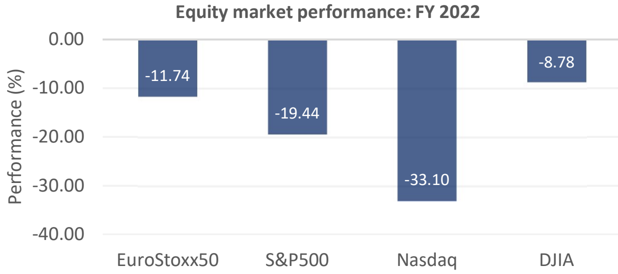
Introduction

Following years of notable gains, 2022 - a year possibly like no other in recent market history - proved challenging. While uncertainty remains, 2023 offers a more constructive view and selectively presents market participants with opportunities as the interest rate path; a major cause for volatility in the previous year, became more clear.

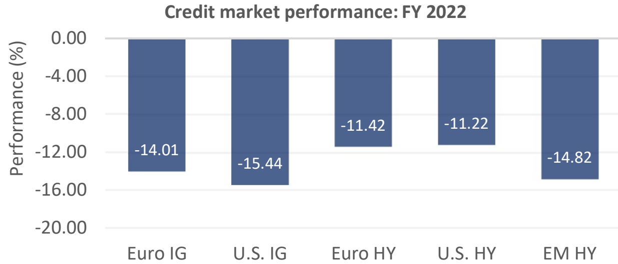
Geopolitical tensions in eastern Europe and central banks' battle against inflationary pressures, have in 2022 took center stage, proving to be the main sources of market struggles. Indeed, markets felt the pinch, ending the year substantially negative, notwithstanding some relief witnessed in the final quarter of the year as market participants clinched to the idea that inflation may have possibly peaked.

The silver lining amidst still a clouded landscape, arose in the final days of 2022. China's surprising decision in favour of less strict Coronavirus restrictions (a prime trigger for elevated inflation over the past years) re-ignited hopes, not only for the Chinese economy, but more importantly for the entire global economy. This, given China's high influence and its noticeable share in global economic growth.

Equity market performance: FY 2022



Credit market performance: FY 2022



Source: ICE BofA Indices, Calamatta Cuschieri Investment Management

The macroeconomic landscape

Euro area

ECB expected to hike further

Notwithstanding the declines observed in headline inflation, (resulting mainly from lower energy prices as food price inflation) inflation projections have been significantly revised up.

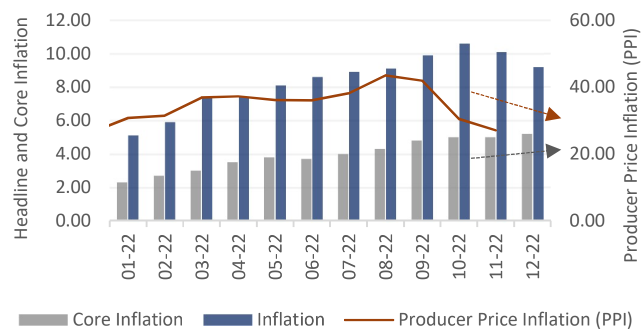
On the back of such projections, the ECB maintains its aggressive approach. The Governing Council judges that interest rates will have to rise significantly to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. Future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach.

Optimism in sight

i. **Private sector downturn fades:** downturn previously envisaged moderates. Preliminary estimates for the first month of 2023 point to an overall expansion, perhaps implying a milder recession.

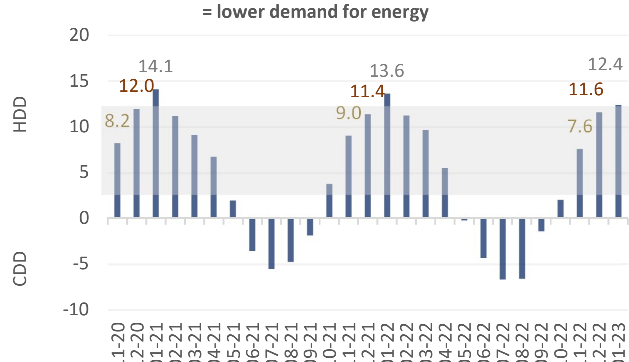
ii. **Inflationary pressures ease CPI and PPI:** notable declines in headline CPI data. Core Inflation (excl. transitory or temporary price volatility) remaining steady, possibly a sign that elevated prices are becoming entrenched. Producer Prices (PPI) (a forward-looking indicator) figures supportive.

Headline, core and producer price inflation

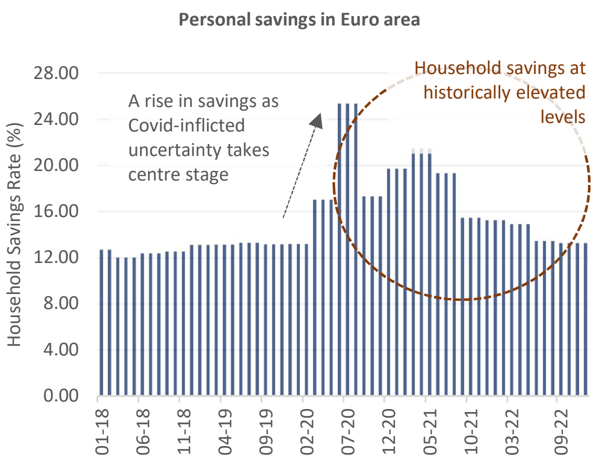


iii. **Weather conditions in Europe allay fears over energy shortages:** subdued demand for energy lessen the pressure on households. In return, **together with elevated savings**, alleviating consumer sentiment and thus demand.

Lower HDD average throughout the 22 – 23 winter season
= lower demand for energy



N.B: A heating degree day (HDD) – quantifies the demand for energy needed to heat a building. A cooling degree day (CDD) - quantifies the demand for energy needed to cool buildings.



iv. **Consumer confidence:** Albeit depressed, consumers' optimism about their household's future financial situation and general economic situation, improves.

Heading into 2023

- Risk of an energy crisis remains, yet proving more manageable. How Europe copes with such crisis depends on; how severe winter turns out to be (thus far proving benevolent), how well-established EU's solidarity is, and how efficiently corporates manage to cut off from Russian gas supplies. Stable savings rate and energy rationing will prove key for Europe.
- Benevolent fiscal measures remain key for consumer resilience.
- Wage growth expectations pointing north, toughening the battle against inflation.
- Higher interest rates will be the new norm-market adjustment needed, implying more yield volatility.
- ECB remains committed to higher rates on the back of delayed actions. The risk of a policy mistake remains.
- Expectations for a technical recession on the back of prolonged sticky inflation, remain. The idea of a shallow and short recession may not be farfetched.

United States

Fed pushes back against the market with a 50bps hike

Consecutive undershoots of inflation led the market to believe we are getting very close to the peak for interest rates, and rate cuts will soon be on the agenda.

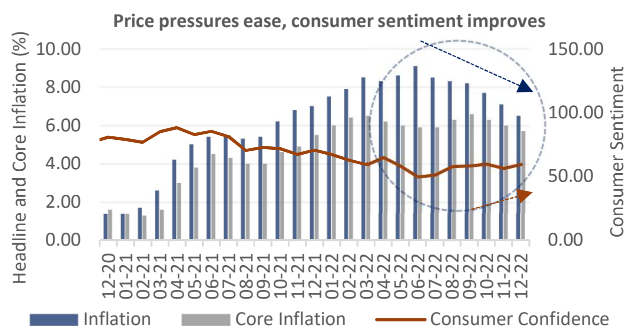
A 50bp hike (in line with market expectations) took the policy rate to 4.25-4.5%. Officials reiterated that "ongoing increases" in the Fed Funds rate will indeed be "appropriate".

Economic Indicators

i. **Albeit moderating, private sector contraction in the US continues into the new year:** Although moderating compared to December, companies continue to highlight subdued customer demand and the impact of high inflation on client spending.
Lower demand for inputs and greater availability of materials at suppliers shall lead to a further easing of inflationary pressures.

ii. **Inflationary pressures cool further:** For a sixth straight month, the annual inflation rate in the US slowed to 6.5% in December of 2022, from 7.1% in November, and in line with market forecasts.

iii. **Consumer sentiment improves**

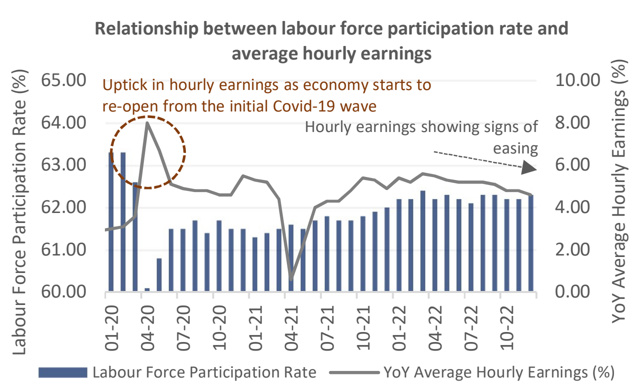


iv. **Jobs data: a silver lining for the Fed**

a. A jump in workforce as labour force participation rate edges higher.

b. Wage growth shows signs of easing. Concurrently, average hourly earnings grew at the slowest annual pace since August of 2021.

c. Hiring proves stronger than expected, yet the lowest almost two years.



U.S. employment market is seemingly starting to act in a way the Fed longed for; eliminating the supply-demand imbalance and help in its fight against inflation. Data possibly depicts a soft-landing narrative, the idea of a strong labour market with slowing wage growth.

Heading into 2023

- Personal savings revolving at historical lows remain a threat to consumption.
- Consumer demand will continue to play a crucial role. Corporate earnings set to be negatively hit. Possibly witnessed as early as Q1 2023.
- Sustained wage growth to increase pressure on companies through higher operational expenditure and thus tighter margins.
- A trend of increasing lay-offs already being witnessed, notably within the banking and tech segment. Such trend may indeed continue to transpire. That said, contained higher unemployment levels will sustain a mild recessionary scenario.

China: the silver lining to a clouded environment

Two years of strict Coronavirus restrictions reversed

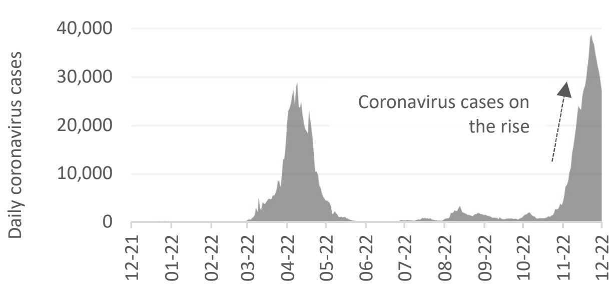
China's economic growth have since early 2020 been constrained. The coronavirus pandemic and ensuing decisions to control it dampened not only sentiment, but also domestic demand, affecting almost all industries, especially those more consumer related.

What transpired?

- Global growth conditioned,
- Triggered global supply-chain related disruptions,
- Elevated supply-driven inflation.

Public outcry and worsening conditions trigger an abrupt U-turn

Protests - a result of the country's unwavering commitment to its dynamic zero-Covid policy - may have well triggered the regime to further ease its coronavirus restrictions, boosting activity. From a political view point, loosening of such measures came to a surprise to both markets and political analysts, expecting the regime to maintain its strict stance, particularly at a time when infections were on the rise. An endemic approach to managing the virus is now seemingly employed.

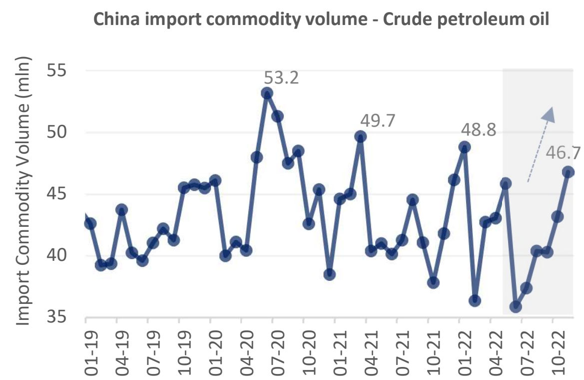


The abrupt U-turn on strict Coronavirus restrictions has been swiftly followed up by other market-friendly changes, targeted towards the debt-ridden property market and tech sector.

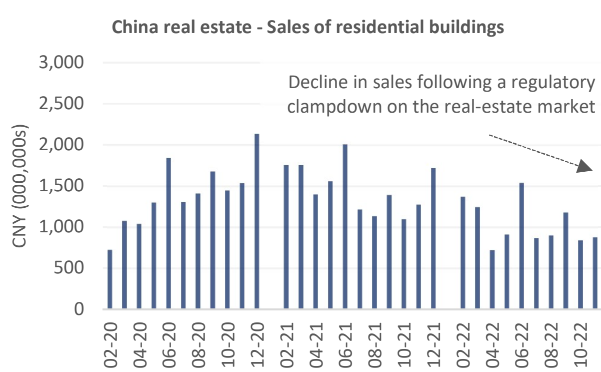
Global markets reacted strongly to such shift in stance.

What may China's big comeback mean?

- Supply-demand imbalance, previously leading to supply-chain related issues, shall ease and help inflation to abate.
- Extended lockdowns weakened demand in the world's largest oil importer, helping to keep a ceiling on prices at a time when energy supplies were tight. Increased demand for crude following such re-opening may possibly threaten weakening inflationary pressures, at the detriment of households.



- If reopening continues apace, selective commodities, may continue to rise on expectations of higher economic activity and increased demand for industrial inputs.
- On the back of strong household finances, consumption should spike domestically. Also, China's re-opening a catalyst for the global economy.
- Travel and retail sectors, notably Europe's luxury houses to benefit strongly from Chinese demand which could roar back.
- Real estate market; regulatory clampdown on indebted developers led to a deterioration in confidence and a notable downturn in sales. While confidence in the segment is not easy to re-instill, authorities are incrementally adding policy support. A temporary turnaround may follow.



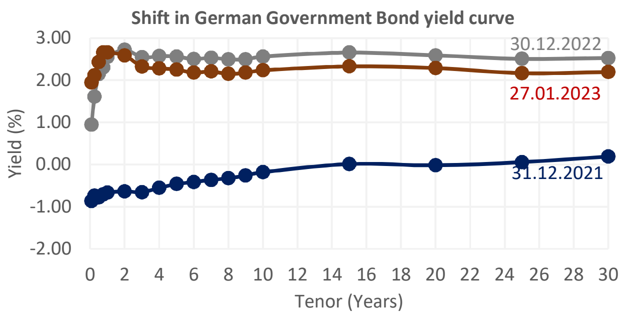
Shifts across sovereign yield curves

Euro area

The ECB raised interest rates by 50 bps to 2.5%, during its last monetary policy meeting of 2022, marking a fourth-rate increase, following two consecutive 75bps hikes.

European Central Bank officials' firm on upcoming decision

- ECB set to raise IR by 50 bps in February and March.
- Officials maintain their view, that it is "too early to tell" if the pace of its rate hikes will slow by the summer.



United States

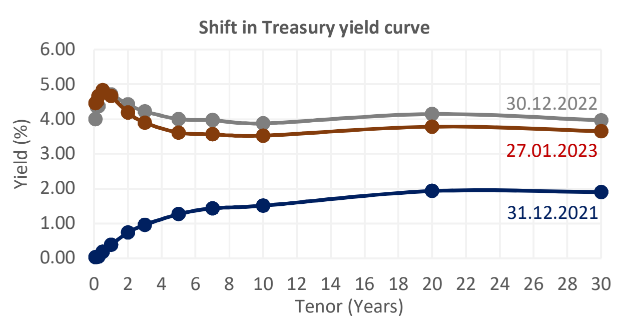
The Federal Reserve raised the fed funds rate by 50bps to 4.25%-4.5% during its last monetary policy meeting of 2022, pushing borrowing costs to the highest level since 2007, and in line with market expectations.

Successive declines in inflation data drive yields lower

Market participants sensing that inflation may have peaked and the Fed may start easing back on its aggressive policy tightening, drove yields lower.

Powell's comments short of details on upcoming decisions

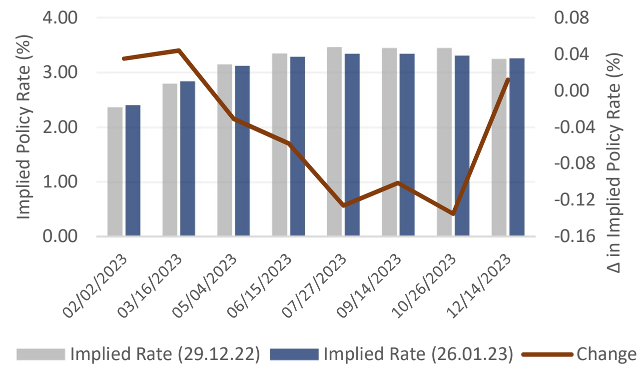
- Markets expectations of a 25bps hike in the upcoming Fed meeting.
- Powell maintains cautiousness, stating; "Price stability is the bedrock of a healthy economy and provides the public with immeasurable benefits over time. But restoring price stability when inflation is high can require measures that are not popular in the short term as we raise interest rates to slow the economy".



Policy action going forward

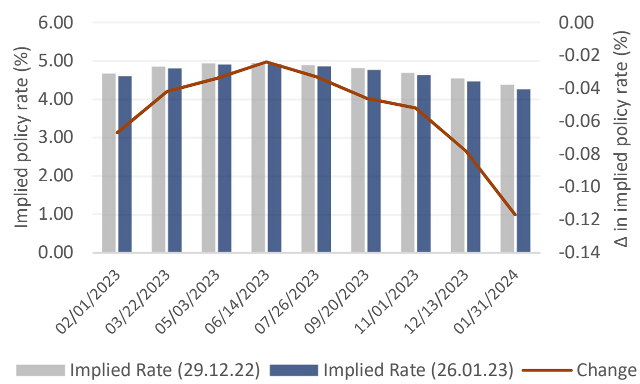
Euro area

- In terms of hikes relative to other central banks, European Central Bank lagged.
- We expect the ECB to maintain its pace of rate hikes consequent to inflation remaining sticky.



United States

- Recent favorable inflation and employment data affirmed markets view of a 25bps hike in the upcoming meeting.
- Reasonable probability remains that the Fed does not align itself with such market expectations, hiking rates by a further 50bps.



Local Market

The local market was inevitably pressured by the higher yields being experienced in foreign markets. Local government bonds were pinched, while the local corporate bond market, as expected, despite at a slow pace, was conditioned by benchmark yields and supply of new issues which offered higher coupons. Meanwhile, the equity market reflected the risk-off mode in addition to the lack of fundamental analysis of selective companies. The outlook remains aligned to ECB actions which will condition yield moves, and thus pricing of expected new MGSs and local corporate bonds.

Outlook

Although uncertainty remains, also from the geopolitical front, we look into 2023 with more optimism. We believe that inflation will be a core element for market performance in 2023.

Provided inflation eases, we could start to see a more benign environment for markets. Compared to the volatility of 2022, we expect interest rates to stabilize, auguring well for the bond market. From the equity front, although possibly witnessing more volatility on the back of recessionary fears, current prices are surely more enticing than they were in January 2022.

Seasoned Investors may well know that historically, some of the best opportunities occur in the midst of recessions and thus selective opportunities should not be ignored or feared in 2023.

Key macroeconomic dynamics in 2023

i. China's relaxation of strict Coronavirus restrictions and thus re-opening a notable positive for the global economy.

ii. Duration of high inflation will condition market performance.

iii. Geopolitical tensions remain a clear threat for markets at large.

iv. Sustained fiscal policy measures, a possibility

v. The risk of monetary mistakes, however remain;

- Policy actions seem to be more aligned to clear trends in economic indicators, which will determine the pivot timing,
- Longer duration bonds remain at the mercy of benchmark yield moves,
- Higher rates shall reflect with a lag into the economy and price pressures may persist for longer periods,
- The aggressive stance might have serious implications in the short-to-medium term,
- Expectations of rate hikes but at a slower pace,
- EM Central Banks preemptive actions pushing inflation lower (E.g. Mexico), an opportunity for investors in search for relatively higher yields, also aided by recent dollar weakening

Trends and Opportunities in 2023

Equity Markets

Despite uncertainty remains and being cautious remains imperative, selective sectors have indiscriminately been pushed lower on risk-off momentum. We believe these offer opportunities:

i. **Tech**: selective mega-caps are trading at interesting levels. As peak rates get embedded in valuations, opportunities are triggered namely in solid cash generating names.
ii. **Healthcare**: year-to-date results remain robust, outlook remains positive, cash generation maintaining an upward trend, and valuations depressed harshly lower.
iii. **Consumer Discretionary**: analytical research uncovers value in selective companies as the '*Veblen'* proposition takes center stage. China re-opening a remarkable boost.
iv. **Consumer staples**: have pricing power. Should navigate well the economic turmoil as demand for such goods remains robust.
v. **Telecommunications**: a historical trend of negative correlation with higher price increases, as connectivity remains imperative.
vi. **Energy**: price levels should remain at current levels in Q1 '23 on the back of geopolitical tensions, China re-opening and possible OPEC+ supply controls. In primis companies that are also investing in green energy projects

Credit Markets

Following the notable spread widening observed, a niche of opportunities has emerged:

i. **Investment Grade (rating bucket play):** repricing on the back of higher yields, pushed lower rated bonds to offer attractive entry points.
ii. **Investment Grade (duration play):** Increasing duration cautiously duration on expectations of lower rate hikes.
iii. **High Yield:** BB/B space proving to be very attractive on the back of a shorter duration vs Investment Grade credit and low primary market activity which has pushed yields to tighten. Companies with no short-term refinancing needs are value.