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Tuesday, 10 January 2023

B Capital Commentary and Outlook Update 2023

"***The only function of economic forecasting is to make astrology look respectable***" - John Kenneth Galbraith

Investors witnessed a step back in global growth during 2022, as global economic activity saw a broad-based and sharper-than-expected slowdown, with inflation higher than seen in several decades. The cost-of-living crisis, tightening financial conditions in most regions, Russia's invasion of Ukraine, and the lingering COVID-19 pandemic all contributed to a darkening outlook. The sudden tightening of financial conditions by central banks added unwelcome volatility leading to criticism that policy makers were reacting too late to the arrival of inflationary data. Playing catch-up, the last 12 months have seen the fastest increase in the Federal funds rate since 1981, and the fastest increase in European Central Bank (ECB) rates since the establishment of the Eurozone.

In 2023, we see a step forward for the global economic picture, but no leap in growth as one might hope. We forecast that global growth will remain positive in 2023, albeit at a weak ~1.9%, as a recovery in China (~3.8%) and likely robust growth in India (>5.0%) offsets weakness in western economies.

Wall Street economic projections vary from more positive outcomes than we forecast to a flatlining global picture in 2023. However there is consensus around the brighter prospects for EM countries and in general a diminishing threat from the soaring inflation seen last year.

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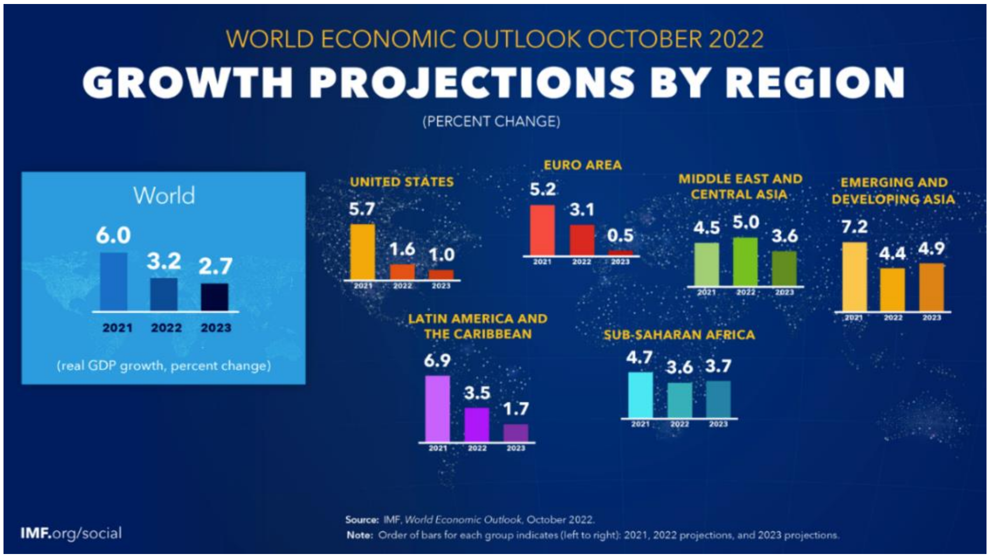

Fig 1 - Global Growth Projections (October 2022)
***Source: IMF**

The last twelve months have been tough for investors. Only commodities posted positive real returns at the asset class level, and portfolios made solely of stocks and bonds have had one of their worst calendar years in a century, according to Bloomberg. The classic stocks and bonds portfolio has been a standard recipe for steady returns for so long that it has been a shock to see it being a recipe for disaster in 2022. The sudden acceleration of inflation being chased by rapid interest rises by Johnny-come-lately central banks disrupted markets sufficiently to cause losses across all asset classes except for commodities and the most popular "60/40" equity/bond portfolio allocation resulted in a -16.03% return for the year, before fees and taxes.

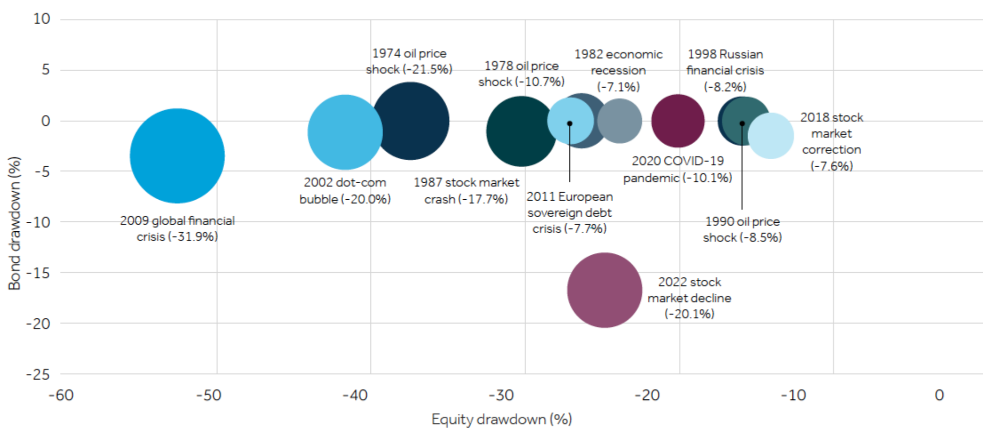

Fig 2 - 60/40 Equity/Bond Portfolio Comparisons 1974 - 2022
***Source: Bloomberg, Barclays Private Bank**

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Broad index returns for equities were slightly better after the final quarter of the year, but still left the MSCI World Index down -17.73%, the S&P500 -18.23%, the European Stoxx600 -14.76% and EM -19.74% on a total return basis and before fees and taxes.

Fig 3 - 2022 Major Index ETF Performance Chart (MSCI World, S&P500, Eurostox600, MSCI EM, China CSI300, US Aggregate Bond)
***Source: Bloomberg**

Typically when a slowdown is anticpated there is negative correlation between stocks and bonds, as the former falls to reflect lower earnings and the latter counterbalances with a rise in prices to react to lower interest rates. The twin effects of higher rates and a slowing economy upended the traditional paradigm for investors and meant that making money was confined to commodities trades and managers able and willing to 'short' markets (ie hedge funds) to bet on falling values. This does not mean however that the classic mix of stocks and bonds has stopped working and in fact this year we expect the yield from fixed income to be a welcome contributor of returns in portfolios. One should use cash to load up on investment grade bonds while yields are elevated and expect these fixed returns to look generous a year from now as yields probably decline and furthermore the diversification will smooth volatility from stockmarkets. The 60/40 strategy will reassert itself this year and is as valid as ever.

With growth running at sub-par levels in the western economies and only picking up speed in 2024, we expect better equity returns from China, India and EM generally as the relaxation of zero Covid policies and lending stimulus in China boost local and connected markets. It will be bumpy and therefore we believe that one should be cautiously optimistic at the outset of the year, looking for signs of improvement before adding to risk, but still maintaining allocations to equities. The fears of recession are not undue so if the best predictor - the US Sovs yield curve (2Y10Y) - is right as it nearly always is, there will be a recession across western regions. In our view it will be shallow for the the US, and somewhat worse in Europe, but not show stopping. We said that peak inflation would be reached in the second half of 2022 and reinforce this view today, with a forecast that CPI in the US will fall below 5% by mid-2023, turning a strong headwind into a more gentle environment that will also see the end of interest rate rises over the next quarter. Equities will find support in this period and will also start to price better earnings expectations in 2024.

Within equities we think that in general the large blue chip companies represented in the developed markets indexes are the better risk adjusted strategy and in particular a combination of sectors that have strong earnings resilience (healthcare, staples, utilities) or benefit from higher rates and energy prices (financials, energy). Some adjustment may follow but it is worth noting that such exposures are already well-represented in the major indexes - for example these sectors make up 45.64% of the MSCI World and 43.10% of the S&P500 indexes. We expect to compound some DM equity price growth with decent dividend yields, and aim to prudently add to our EM equity allocations in balance.

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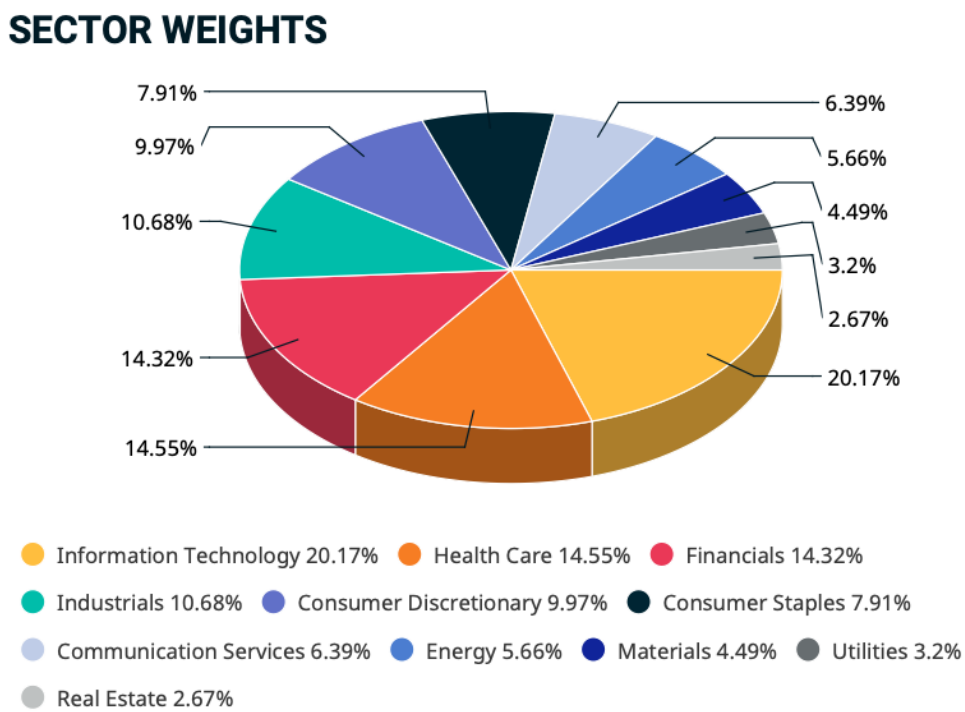

Fig 4 - MSCI World Index - Sector Weights, December 2022
***Source: MSCI**

In HY debt this year, we expect default losses to be stable – with a slightly higher level of defaults than lately but with better recovery rates – which serves to keep our long-term HY spread forecast unchanged from last year. Emerging market debt (EMD) spreads have also widened meaningfully over 2022, and we forecast spreads to be around 400bps for emerging market (EM) corporate debt and 380bps for EM sovereign debt. This translates to return forecasts up ~200bps, to around 7.00%, for EMD corporates and up 190bps, to 7.10%, for EMD sovereigns.

The key economic question for 2023 is whether central banks will be able to bring down inflation to more acceptable levels without a recession, or at least without a deep recession. We are reasonably optimistic, but there are substantial risks to our view. One risk is that inflation pressures simply remain pervasive enough that central banks have no choice but to keep tightening aggressively. If so, a recession might become unavoidable, not just in Europe but also in the US. The recent news flow has reduced this risk slightly in the US, as the labour market continues to adjust and inflation has begun to pull back. As ever, it is different for every region and theses imbalances present both risks and opportunities. Central banks in Europe and those EM economies where inflation is still increasing may be forced into further tightening in an environment of exchange rate depreciation and rising inflation expectations. The strength of the US dollar has much to answer for when stress is building and the Greenback may stay strong for several quarters before giving back ground later this year, in a somewhat normalising period emerging out of slow growth and sticky inflation.

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I trust that this commentary is clear but should you have any questions please do not hesitate to contact me.

Lorne Baring
Managing Director

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