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A Quarter in the Markets

Q4 2022

We are pleased to introduce our latest edition of 'A Quarter in the Markets', which provides an insight into financial markets from the Multi-Asset Solutions team at Santander Asset Management UK.

What were the key factors influencing markets in the fourth quarter of 2022?

Encouraging signs emerged this quarter that inflation may be beginning to plateau. However, the overall picture for the global economy remains defined by stubborn inflation, and the interest rate rises central banks are implementing trying to contain it.

The Federal Reserve (Fed)[1], European Central Bank (ECB)[2] and Bank of England (BoE)[3] all reduced the size of their interest rate rises, shifting to 0.5% increases at their December meetings rather than the 0.75% hikes they had made earlier in the year. This marked a move towards a less aggressive anti-inflation policy by major central banks.

There were also indications that inflation may be cooling. In November, Eurozone inflation fell for the first time in 17 months[4], while US inflation also slowed from 7.7% in October to 7.1% in November.[5]

However, policymakers at the Fed[6], ECB[7] and BoE[8] all nonetheless stressed that inflation will remain a key concern as we move into 2023. Despite the Fed's decision to ease off in December, US interest rates currently sit at their highest levels since 2007[9], with further interest rate hikes possible.

This quarter was also shaped by a continuation of the war in Ukraine, the threat of energy shortages in Europe in the winter of 2023, and growing geopolitical tensions – especially between China and the US. These factors all contributed to an increased risk of a global recession[10], creating an uncertain economic picture as we enter 2023.

What happened in markets during the quarter?

Prior to this quarter, 2022 had been defined by the longest decline for global stock markets since the Great Depression, with three consecutive quarters of losses.[11] However, the fourth quarter of the year saw the MSCI ACWI, which tracks the shares of developed and emerging markets, defy this trend and rise by nearly 10%.[11]

Following six consecutive quarters of losses, bonds were also able to break their losing streak this quarter with a positive return.[12] This uptick in global bond markets may have been down to cooling inflation, combined with the fact that bond prices were low following their sell-off earlier in the year.[13]

However, the improved performance of global stock and bond markets this quarter was not enough to erase the difficulties of the rest of 2022. This year was the worst for US shares since 2008.[14]

Asian shares also endured a difficult 2022[15], with high US interest rates driving investors towards dollar-based assets and China's COVID-19 lockdowns disrupting regional trade.[16]

During the quarter European shares surged by more than 16% from their October lows in November, but they ended 2022 with a 1% fall in December. Their performance over the broader course of the year, like US and UK shares, was negative, with the overall decline in excess of 14%.[17]

Global stock and bond markets together lost more than $30 trillion in 2022[18], leaving investors with few places to shelter from turbulent market conditions. As shares and bonds have historically tended to move in opposite directions, bonds have often served as a safe haven in times of stock market turmoil. However, this year bonds were hit too, with inflation and high interest rates eating into bond prices.

Energy and agricultural prices recorded substantial gains over the course of the year.[19]

How did different economies react?

Despite the UK economy growing by 0.5% in October[20], the economic environment this quarter was significantly less positive. The Office for Budget Responsibility announced that the economy has entered a year-long recession, accompanied by a record drop in living standards.[21]

In Europe, the ECB stressed in its December meeting that rising food prices and other signs of inflation are likely to persist for some time.[22] While inflation eased to 10% in November from 10.6% in October, this decline was likely to have been driven by a fall in energy prices.[23]

In the same December meeting, the ECB also noted that the Eurozone economy may contract in the fourth quarter of 2022 and the first of 2023 due to the energy crisis, weakening global output and high levels of uncertainty. However, the central bank also expressed its view that this contraction was likely to be short-lived, with inflation expected to fall significantly in 2023.[24]

US inflation rose less than expected for a second consecutive month in November[25], paving the way for the Fed to announce an interest rate rise of 0.5% at its December meeting.[26] This was a less aggressive move than the four consecutive 0.75% interest rate hikes that had preceded it[27], and an indication that US inflation may be beginning to level out.

Even so, the Fed has indicated that its work to combat inflation is far from over. While its individual interest rate rises may be less steep than in the past, rates may nonetheless rise to levels higher than previously anticipated and remain there for longer.[28] The central bank's strategy has also been complicated by the fact that the US labour market performed strongly through October and November, placing upward pressure on wages and stoking inflation.[29]

After its economy was disrupted for much of the year by strict lockdowns to contain outbreaks of COVID-19, China lifted restrictions, fuelling optimism that growth in the world's second-largest economy may be stronger in 2023.[30] Efforts to boost economic growth through stimulus measures, along with policies designed to stabilise the property sector have only further bolstered investor optimism.[31]

However, the abrupt reversal of its 'Zero-COVID-19' policy was not without consequence for China. This about-turn spurred a wave of infections, slowing economic activity to its lowest levels since February 2020 as businesses closed their doors and workers remained at home.[32]

What is the outlook for markets?

2022 was a very difficult year for investors, and we believe that many of the same conditions will spill over into the first quarter of 2023. However, our view is that the most likely outcome for the global economy is a slowdown rather than a full-blown recession. We feel that central banks will likely keep hiking rates until inflation is firmly under control, even if individual interest rate hikes are less aggressive.

While markets have already fallen a long way, there is likely room for them to drop even further if the outlook dims. The environment remains negative for shares and bonds, so this is no time to take unnecessary risks.

How are we positioned for the major risks to our outlook?

We continue to assume a cautious stance on shares and bonds, as we believe that risks remain for both. We therefore hold fewer shares than the relevant market benchmarks. We will also continue to look for attractive contracts that will allow us to buy shares for a set price in the future, meaning that a profit can be made if the price of the share increases prior to that date.

We used contracts successfully during the quarter. As we believed that a stock market rally was possible, we set up contracts in anticipation of this. When a rally did occur in October and November, we were therefore able to capitalise on it. We also implemented contracts that would enable us to sell, as well as buy, shares for predetermined prices. If the price of a share declined, this meant that we would still be able to sell it for its earlier price, protecting us from a downturn in the markets.

However, we've been slowly adding risk through buying shares as the quarter progressed. We're now closer to a neutral position in this area than we were at the beginning of the quarter, relative to the benchmark.

When it comes to bonds, we assumed a conservative stance through favouring those that only take a short time to reach maturity. The longer a bond is held for, the more its value may change due to interest rate rises or other factors, so bonds which take a shorter time to reach maturity are less risky. We also hold fewer bonds than the benchmark.

Nonetheless, just as we've been adding risk through purchasing shares, we've also been purchasing bonds which take longer to reach maturity where we believe value can be found.

We're preparing for a shift towards a buy-and-hold approach to strategic asset allocation in 2023, focused on longer-term returns.

As part of that allocation, we've reduced our position in US shares, while also cutting our position in UK shares. We've also significantly reduced our holdings of emerging markets shares, with our focus here shifting to Japanese shares.

The remaining funds have been allocated to an index-tracking fund that emulates the MSCI World Index, which measures the performance of more than 1,500 companies worldwide. In the meantime, we will look for active managers to help us find thematic investments in shares that can generate value.

While our Santander Atlas Portfolio range has held gold throughout the year, we also plan to add the precious metal to our Santander Multi-Index portfolio once we find an attractive entry point to make a purchase.

Our new strategic asset allocation also includes a greater focus on US government and high-grade corporate bonds, and a reduced allocation towards UK and European bonds.

Outlook by asset class

Shares

Our stance on shares and other riskier assets remains cautious, given that the shock of higher interest rates has yet to be reflected in company earnings. Should the global economy slow, as we believe is the most likely outcome, shares have the potential to fall much further than bonds.

Bonds

As central banks continue to closely monitor interest rates, we will approach opportunities in the bond market with caution. However, the fact that inflation and interest rate rises may have peaked offers some grounds for optimism.

Find out more

Learn more, visit our website here for more insights into financial markets.

[1] Federal Reserve, 14 December 2022
[2] European Central Bank, 31 December 2022
[3] Bank of England, 31 December 2022
[4] Financial Times, 30 November 2022
[5] BBC, 13 December 2022
[6] Wall Street Journal, 15 December 2022
[7] Bloomberg, 31 December 2022
[8] Bank of England, 7 November 2022
[9] Bloomberg, 14 December 2022
[10] The Economist, 18 November 2022
[11] MSCI ACWI, 31 December 2022
[12] S&P Global Developed Sovereign Bond Index, 31 December 2022
[13] Financial Times, 23 December 2022
[14] CNBC, 30 December 2022
[15] MSCI AC Asia Pacific ex-Japan Index, 31 December 2022
[16] Yahoo! Finance, 18 December 2022
[17] CNBC, 30 December 2022
[18] Financial Times, 30 December 2022
[19] Financial Times, 30 December 2022
[20] Office for National Statistics, 12 December 2022
[21] The Guardian, 17 November 2022
[22] European Central Bank, 15 December 2022
[23] Eurostat, 30 November 2022
[24] European Central Bank, 15 December 2022
[25] Reuters, 13 December 2022
[26] Federal Reserve, 14 December 2022
[27] Yahoo! Finance, 14 December 2022
[28] Reuters, 14 December 2022
[29] CNBC, 2 December 2022
[30] China Daily, 28 December 2022
[31] Bloomberg, 18 December 2022
[32] Bloomberg, 31 December 2022