INTERNATIONAL LONG-TERM UNCONSTRAINED

Investment Outlook Update

MARTIN CURRIE
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'The reopening of China could help avoid a global economic recession'

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This month we highlight several important aspects of our 2023 outlook, released in December 2022. Specifically:

- **Monetary policy expectations in 2023 will continue to be an important determinant of market direction and style leadership.** While the key rate-setting meetings in December were hawkish in tone, there is an ongoing possibility that central bank resolve to tackle inflation in 2023 could be superseded by a rapidly deteriorating macroeconomic backdrop. Although this is not the rhetoric from central bankers at the moment, due to the importance of maintaining credibility, we could see a game of 'chicken' developing during the course of 2023, should leading indicators continue to deteriorate.
- **We maintain our view that a sharp slowdown at the global macroeconomic level is the most likely scenario – with economic momentum in part determined by China.** On the macroeconomic front, global economic momentum will in part be determined economic momentum in China, given it is the second-largest economy globally. After the sudden and rapid shift in policy stance on Covid from the Chinese authorities, our central view is that China's reopening could increase the likelihood of the global economy avoiding a recession in 2023.
- **The reopening of the Chinese economy could prove very supportive for European companies.** Europe, and companies quoted on European stock exchanges, are exposed to China by some noticeable measure, and are dependent on its economic cycle, particularly some of the Consumer and Industrial companies. More positive and sustained momentum in the Chinese economy could therefore be supportive for Europe, in our view.

Below, we outline our thoughts on monetary and central bank policies, the macroeconomic outlook, and include an updated view on China's zero-Covid policy from our 2023 outlook. We have also provided our summary of key indices both over December and 2022.

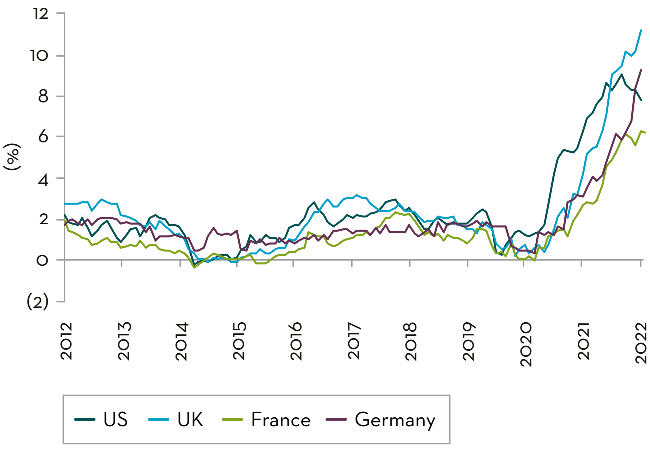
Monetary policies will dictate market volatility and market direction in 2023

- Macro backdrop will continue to dominate markets
- Monetary policy expectations to drive style leadership between Growth and Value
- Any firm evidence of inflation peaking could lead to a downward adjustment in monetary policy expectations, supportive for both equity markets and Quality Growth stocks
- Central bankers' focus remains on inflation, but could shift towards growth in 2023 if recessionary concerns grow

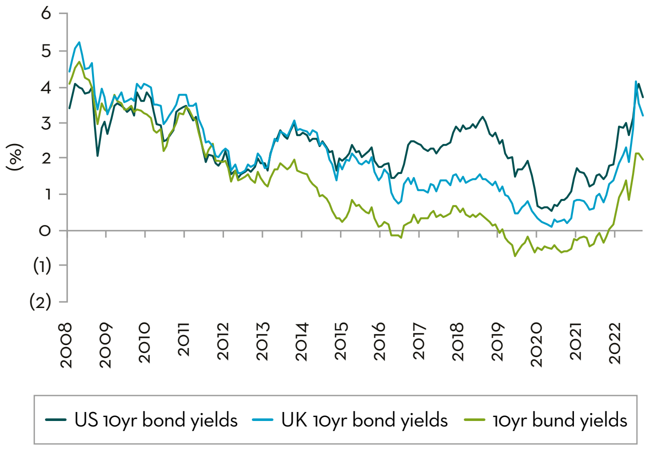
Looking to 2023, we believe monetary policies will remain the key determinant of both equity market direction and style leadership between growth and value. Shifting monetary policy expectations have been the dominant driver of share price returns in 2022. We expect this to continue whilst we remain in an environment uncertain about inflation and around how much central banks should raise interest rates to combat inflationary pressures. In 2022, central banks were clear about their focus on inflation – effectively changing tack from propping up growth, to doing "whatever it takes" to reduce inflationary pressures. During the course of 2023, should inflationary prints overshoot expectations, monetary policies will likely need to be adjusted further upwards. This will weigh negatively on equity returns and, in turn, on the Quality Growth style, to the benefit of Value. Inversely, as seen with December's inflation prints, if inflation undershoots, monetary policy expectations will adjust downwards. This will be more supportive for equity markets, and for the Quality Growth style.

There is a likelihood that central banks start turning their attention towards growth, if recessionary concerns become significant, as we detail below.

Headline CPI inflation on a monthly basis (%)



Global 10-year bond yields (%)



Source: Martin Currie and FactSet, as 30 November 2022. CPI is shown to 31 October 2022.

The macro-economic outlook is pointing to a sharp slowdown globally in 2023, with Europe already likely entering into stagflation

- Leading indicators are continuing to weaken across regions
- A sharp slowdown in global economic growth remains our core scenario
- China's economic cycle will dictate global cycle momentum in 2023, with the sudden covid policy shift and rapid reopening likely to lead to a more supportive backdrop
- Stagflation is the more likely scenario in Europe, for now, although once again China will influence the momentum in that region too
- The US should also see a sharp slowdown in economic growth, but could avoid a recession

With leading indicators continuing to deteriorate across key regions globally, both on the manufacturing and services side, we believe 2023 will be a year of low global growth. The US could avoid a hard landing, but Europe is likely to be heading into stagflation.

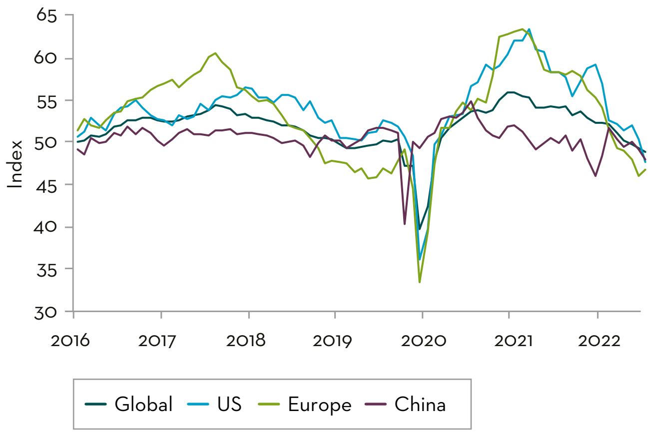
Over the next 12 months, we maintain our probability of sharp slowdown in global economic growth at 65-70%, and the probability of stagflation at 30-35%. A key determinant of the global economic cycle will be the Chinese economy, being the second-largest globally. It will be difficult to predict the momentum in the Chinese economy, given the sizeable increase in Covid cases since China's sudden and rapid U-turn on its zero-Covid tolerance. The policy shift , and a full re-opening of the Chinese economy, is likely to lead to a rapid improvement in Chinese leading indicators, which should in turn lead to an improvement in the global economic cycle.

For Europe, whilst we maintain our probability of stagflation at 70%, with the expectation of sharp slowdown at only around 30%, it is worth highlighting that Europe's economic momentum will be significantly influenced both by Chinese leading indicators, (given its exposure to that economy), and the more cyclical exposure of European regional markets. A positive stance on China's economic cycle could lead to a more positive stance on Europe's economic outlook as well.

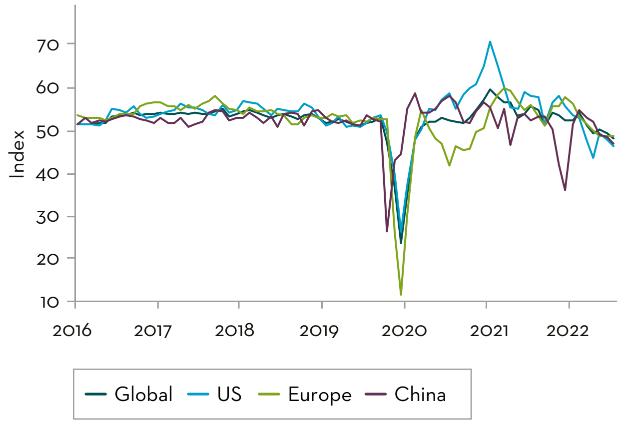
As we make our way through winter any renewed risk of energy rationing could apply further downward pressure in economic activity during the second half of the year. As a result, energy supply risks in Europe may come back into focus during the summer and beyond.

Purchasing Managers' Index (PMIs)

Manufacturing PMIs



Service PMIs



Source: Martin Currie, FactSet and OECD as at 30 November 2022.

Central Banks will be playing a game of chicken in 2023

- The anticipated pivot from central banks will be a focal point throughout 2023
- Weaker economic momentum could test the resolve of central banks to prioritise dampening inflation, particularly for those central banks with dual mandates relating to inflation and economic growth
- We could foresee a situation whereby central banks temporarily tolerate an inflation level in the 3-5% range, should economic recession become a significant risk
- The anticipation and timing of central bank pivots could mean high volatility in markets, and across Growth and Value styles
- We believe that the anticipation of central banks merely ending their hiking cycle, rather than announcing a policy shift to cutting rates, could be enough to bring support to equity markets and to the Quality Growth style of market leadership

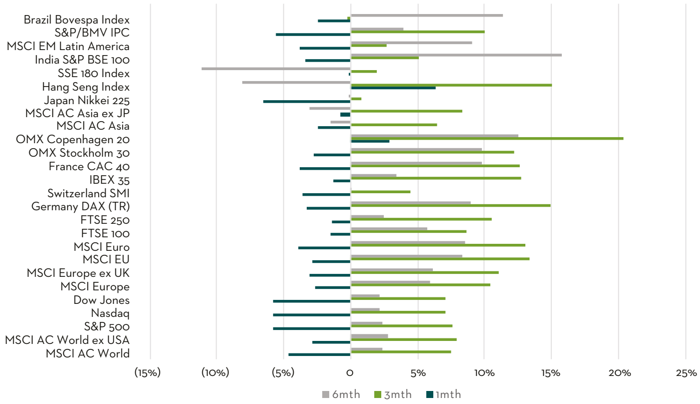
In 2023, we believe that central banks are faced with a game of 'chicken': their resolve to fight off elevated inflation could be superseded by their concerns for economic growth, especially if sharp deterioration in economic momentum increases the likelihood of recession. This is particularly the case for central banks with dual mandates relating to inflation and growth, such as the US Federal Reserve (Fed), but could also be the case for other major central banks such as the European Central Bank (ECB). We could, therefore, have a scenario where central banks tolerate a somewhat higher inflation level of c.3-5%, to prevent pushing economies into recession. Could the Fed return to the average inflation targeting policy that it briefly took up before inflation escalated to current levels? It will be an interesting aspect to observe.

One sure prediction for 2023 is that the word "pivot" will be used aplenty, and central bank pivots will be an extensive talking point. The timing of monetary policy pivots, and anticipation of such events, will drive market volatility and generate a healthy bull-bear debate in markets.

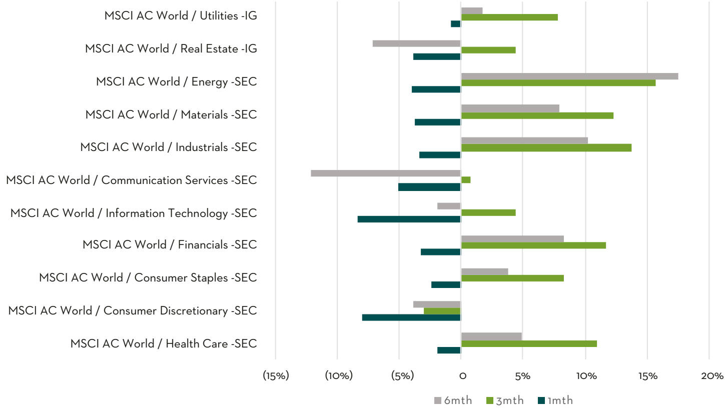
That said, markets may not need central banks to pivot from rate hikes to rate cuts to bring support for equity markets; all that might be required is a stabilisation in interest rate expectations and anticipation of the end to the hiking cycle. This could be supportive in our view, both for equity markets, and Quality Growth style leadership versus Value.

Key markets, sectors and asset class indices moves over one, three and six months

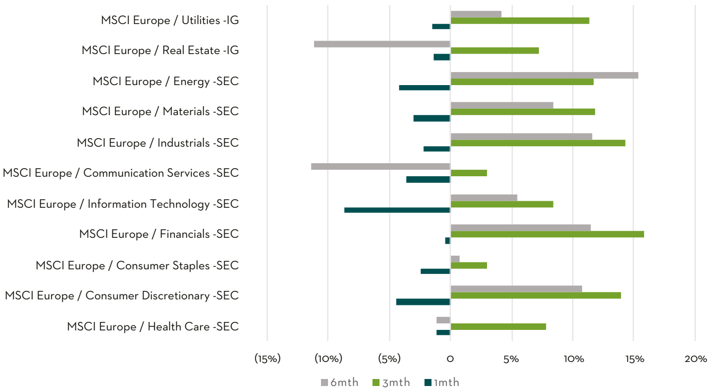
World Equity Indices Performance (%) local currency



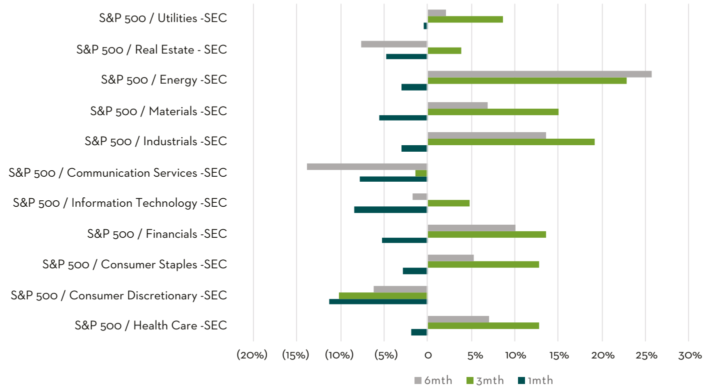
MSCI World Sector Performance (%) local currency



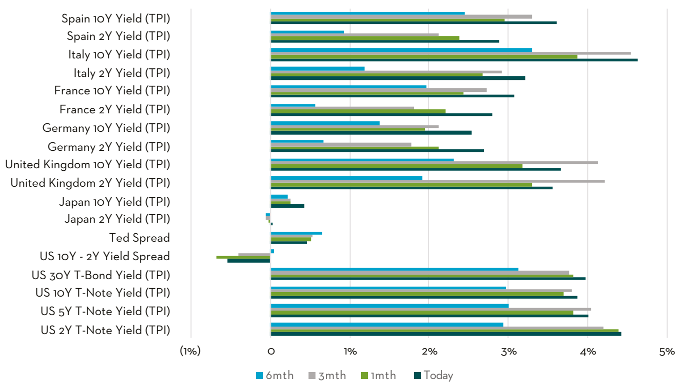
MSCI Europe Sector Performance (%) local currency



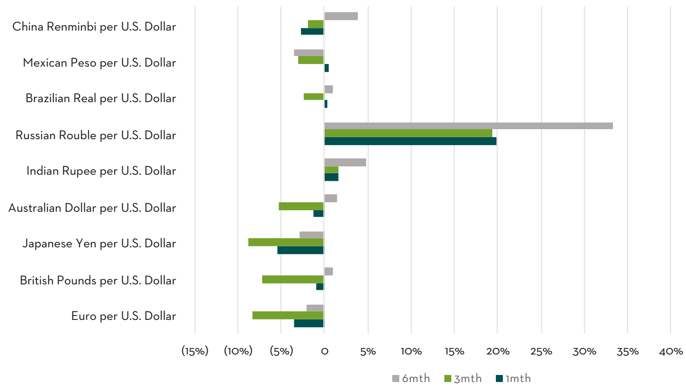
S&P 500 Sector Performance (%) local currency



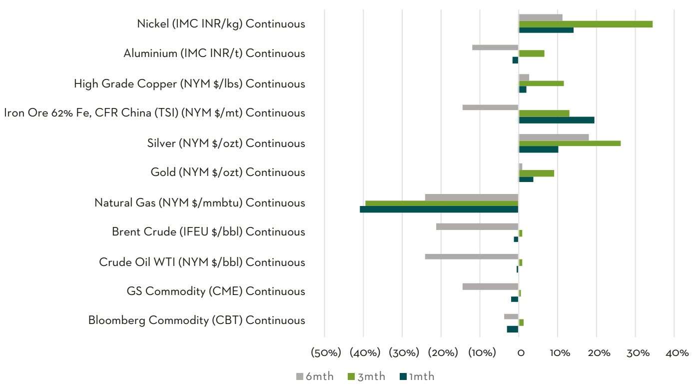
Bond Markets



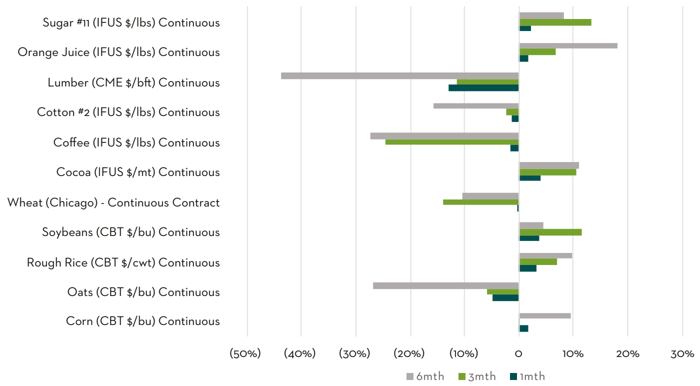
Currencies Performance (%)



Hard Commodities & Energy Performance (%) local currency



Soft Commodities Performance (%) local currency

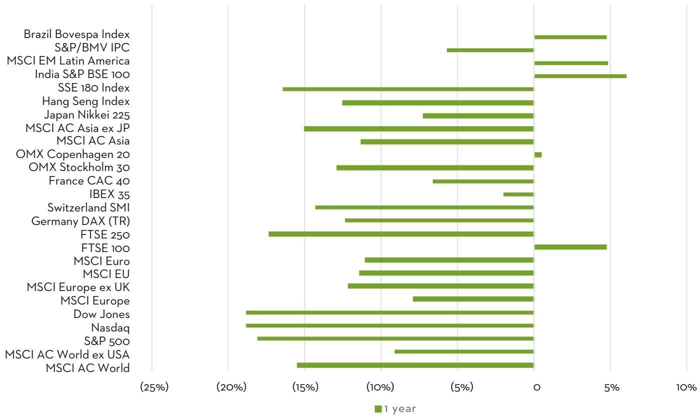


Past performance is not a guide to future returns.

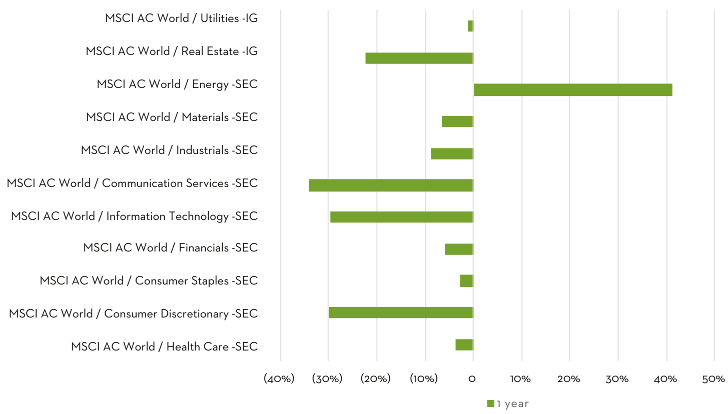
Source: Martin Currie and Factset as at 31 December 2022.

Key markets, sectors and asset class indices moves over 12 months

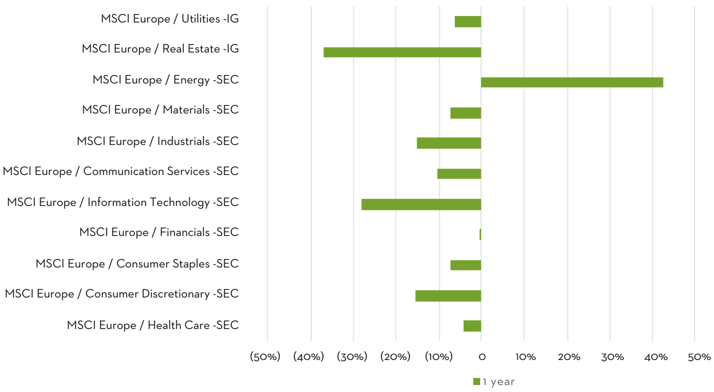
World Equity Indices Performance (%) local currency



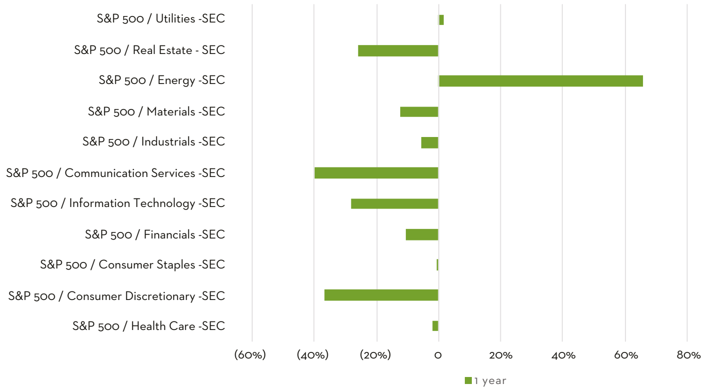
MSCI World Sector Performance (%) local currency



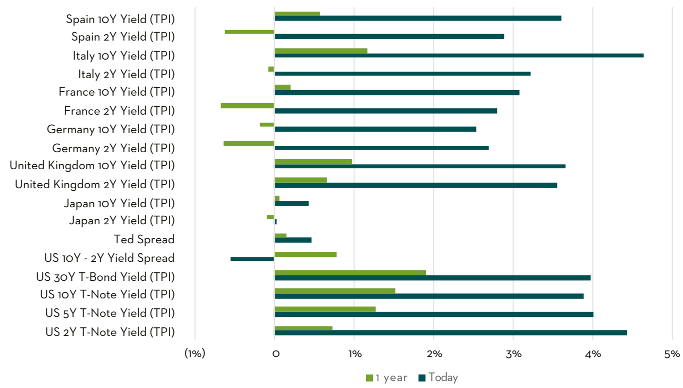
MSCI Europe Sector Performance (%) local currency



S&P 500 Sector Performance (%) local currency

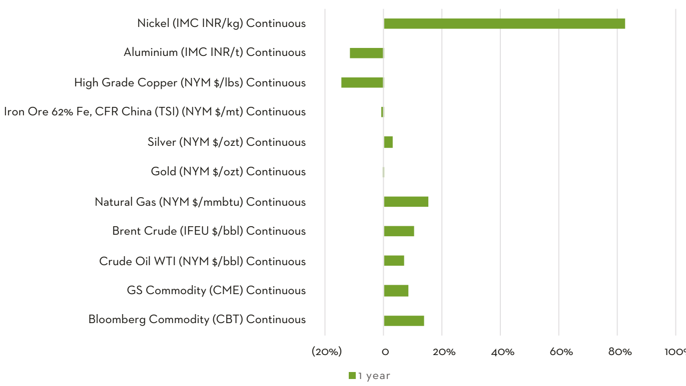


Bond Markets

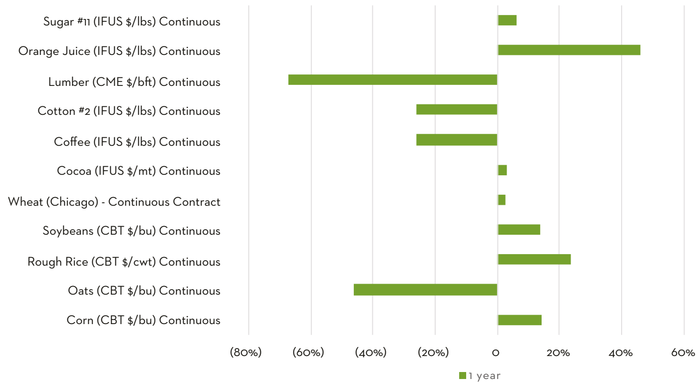


Currencies Performance (%)

Hard Commodities & Energy Performance (%) local currency



Soft Commodities Performance (%) local currency



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Source: Martin Currie and Factset as at 31 December 2022.

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