GLOBAL LONG-TERM UNCONSTRAINED

Monthly Market Update

MARTIN CURRIE
A Franklin Templeton Company

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To pivot or not to pivot – that is the question

Will central banks prioritise growth or inflation?

Contents

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To pivot or not to pivot – that is the question

We believe a pivot from central banks will *remain the key talking point* for markets throughout 2023, with a risk of weaker economic momentum potentially testing their resolve to focus solely on inflation.

In 2023, we believe that central banks are being faced with a game of chicken: their resolve to fight off elevated inflation could be superseded by their concerns for economic growth, especially if we see a sharp deterioration in economic momentum, and a higher likelihood of recession. This is especially the case for central banks that have dual mandates of 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 in 2023 where central banks tolerate a somewhat higher inflation level of c.3-5%, to prevent pushing economies into recession. Could the Fed return to its average inflation targeting policy, that it briefly took up before inflation escalated to current levels? It will be an interesting aspect to observe.

Whilst we started to see some undershooting of inflation prints in the back end of 2022, more recent prints in 2023 have been mixed to slightly higher depending on the region, and while we believe these inflationary pressures are frictional, related to supply chain disruptions and production bottlenecks, the risk remains that the current elevated (frictional) inflation levels could be longer lasting in 2023.

It remains in our view, that all eyes need to stay on wage inflation. Whilst wage inflation trends are not particularly elevated in Europe, UK, Australia or Japan, wage growth in the US has been stronger and accelerating, which could lead to a risk of frictional inflation turning more structural in the US. The base effect of 2022 should help bring headline inflation rates to lower levels in 2023, so there is a good likelihood that inflation could be in the process of peaking, in the absence of an acceleration in wage inflation.

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

From our point of view, we believe that we might not need central banks to pivot from rate hikes to rate cuts to bring support for equity markets; all that the market might need is a stabilisation in interest rate expectations, and an 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.

With lacklustre earnings growth – 2023 could be year of negative growth for markets, such as Europe

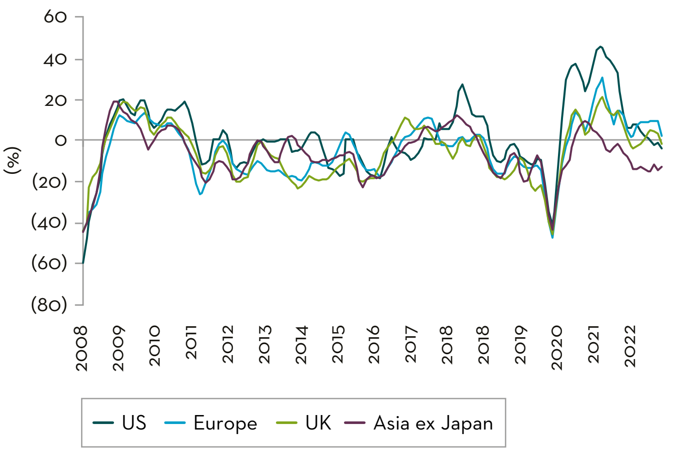
Weaker leading indicators are likely to lead to ongoing downward earnings revisions, with a need to watch out for pricing pressure on corporate margins.

Earnings momentum turned negative from early 2022, with the tragic Russian invasion of Ukraine, and the Chinese regional lockdowns. Economic leading indicators have been deteriorating since then, which in turn have led to a rapid downturn in earnings momentum. Prior to the Q3 reporting season Earnings growth expectations moved from teens growth at the start of the 2022, to low-single-digit growth at European, US and MSCI World level.

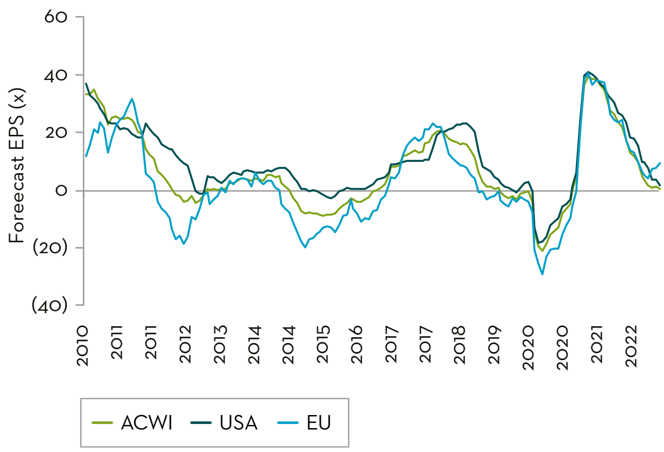
Since then, with the support of the outsized growth being achieved in the Energy and Utilities sectors, and US dollar strength, European growth expectations have recently shifted above 2022 estimates, due to the outsized growth being achieved in the Energy and Utilities sectors, and US dollar strength. As expanded on in our February 'Stock insights' document, the Q4 reporting season has seen a significant negative earnings surprise for European companies, pointing to margin pressure coming through. This has been less pronounced in the US, likely a reflection of the impact of higher energy prices weighing on European companies.

Earnings momentum of given equity markets

Changes in estimates of following year earnings to 30 November 2022



Forecast EPS growth NTM of given equity markets



Source: FactSet and MSCI as at 31 January 2023.

With the ongoing weakening in leading indicators however, we believe that earnings revisions are likely to remain negative in 2023. The table below shows consensus forecasts versus our own top-down estimates. There is a high degree of forecast risk in these estimates, given the high level of macro-economic uncertainty.

Earning Growth	Consensus	Martin Currie estimates
MSCI World	+1%	-1%
MSCI North America	+2%	0%
MSCI Europe	+2%	-5%
MSCI Asia	+2%	+2%

Source: Martin Currie, FactSet and MSCI as at 31 January 2023.

We believe that, given the sharp slowdown in which economies are heading into, we are more likely to see a year 2023 with no-growth in corporate earnings at best, or even negative growth for some geographies. We therefore expect downward revisions in consensus estimates and expect a higher risk of earnings downgrades in the cyclical parts of the market.

In this environment where there is a heightened risk of earnings downgrades, we believe it is critical for us to focus on companies with resilient earnings, and pricing power, that can therefore protect their margins from the ongoing higher inflationary pressures.

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