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SHANE WATKINS: Time to be greedy when others are fearful

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At the beginning of 2022 we cautioned that it would be a tough year for investors. And indeed, returns last year were very bad.

So much so that according to Bank of America Merrill Lynch, a traditional pension fund portfolio consisting of 60% equities and 40% bonds, delivered its worst return in 100 years. It was also the first year in 150 years that US stocks and long-term bonds both exhibited double-digit declines.

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But why were returns so bad? There are two reasons, one related to the unusual positive correlation in the performance between equities and bonds, and the second to inflation.

Returns in equities and bonds are not normally positively correlated. The reason we construct portfolios from both asset classes is to diversify risk. However, in 2022 both equities and bonds were affected by the same event, rising interest rates. And therefore, both asset classes delivered negative returns during the same period and no diversification benefit was experienced.

The second issue affecting returns was unexpectedly high inflation. Real returns are nominal returns adjusted for inflation. In 2022 nominal returns were severely negative and inflation was also very high, in some geographies the highest in 40 years.

The S&P 500 fell 19% and the Nasdaq 33%. But when you consider that US inflation breached 8%, then the real returns experienced by investors in those assets were actually -27% and -41%, a truly appalling outcome.

The question is how to position portfolios for 2023. On only four occasions in the past 100 years has the US equity market suffered back-to-back drawdowns. Paraphrasing Warren Buffett, is this the opportunity to be greedy when others are fearful? While the future is inherently uncertain, based on the information presently available, our answer would be yes, we expect 2023 to be substantially better.

There are numerous reasons to be more optimistic. First, asset prices are much lower now than at the start of 2022. Second, we are about to start cycling a very high inflation base, meaning that the 2023 inflation rate will be much lower. It was this previous very high inflation that resulted in higher interest rates — so, as inflation moderates, so too will rate hikes. And third, China is reopening after three years of a Zero Covid policy. This should underpin Chinese equities and demand for commodities.

While 2022 was dominated by inflation concerns, we expect a pivot to worries over low levels of growth. The IMF expects one-third of the world economy to be in recession in 2023.

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The largest economy in the world, the US, is expected to enter a mild recession. We expect to see interest rate cuts in the latter half of 2023. Globally, company earnings are expected to be very poor in the first half of 2023. But the stock market tends to look forward at least six to 12 months. And by then interest rates could be lower and earnings could be recovering.

Of course, the bounce in asset prices will be uneven. Not everything will do well. But we are particularly optimistic about the outlook for emerging markets. We have had a decade of dollar strength, which has re-elevated US asset prices, to the extent that the US market capitalisation is 63% of that of the global equity market, despite the US economy making up less than 25% of global GDP. With a weaker dollar, money could begin to flow to geographies other than the US.

In the emerging markets universe China is the largest, with the country making up about 30% of the Global Emerging Markets index. It is cycling a particularly low base and has begun reopening after abandoning Zero Covid, and is the one major geography where there is an injection of liquidity into the system by the central bank.

Chinese GDP is expected to increase about 4% in 2023. Much depends on the ability of the government to reactivate the country's economy through various stimulus measures. And Chinese asset price appreciation will require interventions that entice back foreign capital that has detached from China after some decidedly market-unfriendly actions.

SA's economy makes up about 3% of the Global Emerging Markets index and could also do well despite the obvious own goals, such as load-shedding and lack of service delivery.

We are a commodity exporter and our major import is oil, which has come down in price quite a bit of late. Our economy has demonstrated extraordinary resilience. We are positive on companies that will benefit from a reopening after Covid-19, such as hotels, hospitals, casinos, entertainment and some sectors of retail.

We are starting 2023 with very low expectations. The World Bank has downgraded global GDP growth to 1.7% in 2023 (about half of the growth that was expected only six months ago). With these subdued expectations we believe that there are now good opportunities to have slightly more risk dialled into your portfolio. Remember, for prices to go up we do not need good results, only results that are better than expected.

• Watkins is chief investment officer of All Weather Capital.

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