



INVESTMENT REPORT 2023 – PART 2

HOW TO
COPE WITH
A NEW
REALITY?

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“ 2022 will be remembered as a pivotal moment for the global investment community ”

In this report, Roger Camrass presents his personal views on investment prospects for 2023 together with a review of events during 2022. This follows a report published mid 2022 entitled Investment Report 2023 Part 1: the Great Revaluation – Growth or Value Assets¹. Being responsible for his pension for some thirty-five years, Roger has followed global markets closely each year and summarises trends in his annual investment reports. As the research director of CIONET, Europe’s largest community of digital leaders², Roger can witness developments first hand across the entire digital landscape.

2022 will be remembered as a pivotal moment for the global investment community when after nearly fifteen years of near zero interest rates we saw the end of ‘cheap money’. We also experienced inflation rising to double figures – reminiscent of the seventies. Entering 2023, we face a new reality where uncertainty prevails, and the current bear market persists. Safety is the order of the day with a focus on fixed interest bonds and value stocks.

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Investment options for 2023

As investors we are painfully aware of the crippling forces that have depressed equity and bond markets since February 2022 such as rate hikes, double digit inflation and the war in the Ukraine. Diversified portfolios have lost between 10% and 20% of their value during this time. The challenge now is to plot a safe course within a turbulent and uncertain financial landscape. Here are some personal views on possible ways forward.

Welcome to a 4% world

In just twelve months (2022) central banks have raised their rates from near zero percent to 3.5-4.5% (e.g., UK’s BoE, and the USA’s FED). This terminated a fifteen-year era of cheap money following the 2008 financial crisis that fuelled market speculation and kept zombie companies alive. At the same time, the war in the Ukraine escalated energy prices (both oil and gas) which further accelerated nascent inflationary forces, pre-2022, to double digits

across Europe and the USA. The effects of these pivotal developments is leading to a 4% world as seen through the following leading indicators:

- Two-year Gilts up from 0.5% to over 4%
- One-year fixed interest bonds now at 4%
- Central bank rates heading into 4% territory
- Inflation projected to decline to 4% by year end
- Value stocks and funds delivering 4-5% yields

This sets a clear baseline for low-risk investors who are willing to wait out the current bear market which started 11 months ago and is likely to last for at least another 6-12 months.

A year in two halves

Although it is hard to find consensus amongst investment analysts, the general view is that for 2023, we face a year in two halves. Central Banks are expected to continue to raise rates by up to one percent (UK and USA) with larger hikes anticipated across the EU (now at 2.75%). Such moves are aimed at tackling unprecedented rates of inflation. However, a collapse in energy prices and a return to supply chain stability have helped to take inflation down over the final months of 2022 with prospects of a return to the 2-4% range by year end of 2023. This could halt aggressive rate hikes and prepare the ground for a retreat in central bank rates during the second half of 2023.

Higher rates spooked the equity markets in 2022 by reducing the net present value (NPV) of future corporate incomes – especially in the case of growth (e.g., Tech) stocks who are geared to delivering compounded returns over time. The new reality of higher rates has impacted both the S&P 500 and NASDAQ that were highly inflated during the era of cheap money. Price to Earnings (PE) ratios have fallen dramatically, bringing market values down by 19% for S&P 500 and 33% for NASDAQ. Only the FTSE 100 escaped such cataclysmic falls due to its dependence on value stocks such as energy, mining and defence all of which fared well during the downturn. The FTSE 100 was the only lead equity market to end on a positive note (including 4% dividend yield). See Table 1 below:

Table One – equity market indices movements in 2022

Equity markets	Price movement from 1st January 2022	Final level 30th December 2022	Previous year's performance
S&P 500	-19%	3,839	+27%
NASDAQ	-33%	10,466	+23%
FTSE 100	0.0%	7,451	+14%
FTSE 250	-20%	18,853	+17%
DAX	-12%	13,923	+17%
CAC 40	-9.5%	6,473	+30%
China SSE	-13.1%	3,123	+0.5%
Japan Nikkei	-12.3%	25,717	+7%

Analysts expect further rate hikes through the first half of 2023 with associated declines in stock prices. Worst case scenarios suggest that the S&P bottoms out at between 3,000 and 3,200 (compared to current level of 3,800). Thereafter it is likely that central bank rates might stabilise or reverse with a possible revaluation of key equity markets by year end.

In comparison to equities, Gold had a positive year, gaining 1.7% and ending the year at \$1,830. Oil was up 6% at \$80.5 having peaked at \$123 during the year.

Why a five-year investment horizon makes sense

Despite the poor behaviour of most major equity and bond markets in 2022, the historic five-year figures look very attractive to long term investors:

- The MSCI World index was down nearly 20% in 2022 but has achieved an annualised increase of 7% since 2017
- The S&P 500 was down 19% in 2022 but has achieved cumulative growth of 54% over five years equivalent to 9.9% annualised growth (where dividends are reinvested)
- The FTSE 100 was stable in 2022 and has achieved a 40% growth over five years, where dividends are reinvested
- The NASDAQ was down 33% in 2022 but has achieved growth of 79% over the last five years.

Examining leading value funds, the five-year range has been 40-50% returns, and for growth funds returns have exceeded 80%. In all such cases, the rationale for a five-year view looks extremely attractive compared to a yearly outlook.

What are the implications for investors?

The investment landscape described above suggests a cautious approach to equity and bond markets for 2023. Given the likely duration of the bear market through 2023 and beyond, a trickle feed of money into key equity and bond markets would appear to be a safe option. One-year fixed interest bonds delivering a 4% return provides a safe hedge for cash during the anticipated market perturbations of 2023. We have experienced several market rallies in 2022, but none have reversed the bear market trend during the year.

The argument between value and growth stocks as described in the Investment Report 2023 – Part 1 remains consistent for the rest of 2023. Some sectors such as Energy, Mining, Healthcare, Consumer Staples and Infrastructure could offer a relatively safe haven for equity investments during the year, but broader market ETFs such as MSCI World, S&P 500 and FTSE 100 might help avoid value traps should defensive sectors suffer downturns.

Review of 2022 – macro factors

We have already mentioned many of the factors that led to a market melt-down in 2022 such as double-digit inflation, end of cheap money, war in the Ukraine, supply chain disruption. These have contributed to a dramatic end to a twelve-year year bull market following the 2008/9 financial crisis. Such factors have imposed a heavy burden on consumers in terms of rises in weekly outgoings (such as food, energy and mortgage payments) and a sharp drop in value of their savings. Despite this, employment levels have remained relatively high across the USA and Europe. The more concerning trend has been the rise in global debt, now standing at \$290 Trillion with USA debt rising to 140% of GDP thanks to generous handouts by the Biden government, and 100% in the UK fuelled by COVID. Some of the most important developments of 2022 are described below.

The big tech crashes

The rise in interest rates had a dramatic impact on tech stocks. The MAAAM group of Big Tech stocks (Meta, Apple, Alphabet, Amazon and Microsoft) were hit hard despite strong cash flows. Apple declined by 28% (equivalent to a loss of \$1 Trillion); Amazon and NVIDIA shares halved in value; and Tesla and Meta declined by over seventy percent. Tech funds such as AXA Framlington, ARK Investments and Scottish Mortgage were down by similar amounts. The Crypto Winter brought down several currencies and exchanges (the worst being FTX). Bit Coin and Ether survived but depreciated by over two thirds of their 2021 values.

The consequences are that tech continues to trade at a premium to value stocks (as judged by PE ratios), but the gap has been narrowed. The S&P 500 has a PE in the range of 15-16 compared to the NASDAQ that hovers above 22. Recently tech PE values were in the range of 40-50, roughly double those of the S&P. Companies such as Apple and Microsoft resemble value stocks today rather than high growth equities. Both have strong balance sheets and are highly profitable. Apple plans a \$90 billion stock buy-back in 2023 which is exceptional for any high-tech company. It remains a favourite for Berkshire Hathaway. See Table 2 below.

Table 2 – MAAAM stock performances in 2022

MAAAM stocks	Current PE ratios (Jan 2023)	Stock price decline in 2022
Meta	11	61%
Alphabet	17	36%
Amazon	79	48%
Apple	20	28%
Microsoft	26	27%

In the absence of 'cheap money' Venture investment remains hard to get, forcing many start-ups into liquidation. Private Equity has a longer-term investment horizon and deeper pockets. Venture Capital Trusts (VCT) in the UK remain popular with investors who seek to participate in private companies. They also carry attractive tax benefits and can produce 7-8% annual returns.

Geo-political developments

2022 demonstrated the continuing disparities between democratic nations in Europe and the Americas, and autocracies such as Russia, China, Iran, Saudi Arabia and North Korea. The war in the Ukraine was entirely unprompted and has led to near global condemnation of Russia. It has also threatened vital energy supplies into Europe with consequent escalation of gas and oil prices. The outlook for 2023 does not look promising.

UK isn't working

Despite low employment numbers (below 4%), 600,000 people resigned during and post Covid. Up to nine million people are economically inactive. Brexit has failed to deliver any benefits and has cost £40 Billion so far. The NHS is at breaking point with seven million patients awaiting treatment. Rail, Post and Health workers are on strike. Despite three changes in Prime Minister during 2022, government seems unable to address any of the big problems facing the economy. Productivity and economic growth remain stagnant. The FTSE 100 benefits from 75% overseas revenues and is not representative of the UK economy.

National disparities may unsettle the EU

Rate hikes by the European Bank may cause difficulties for nations with weak balance sheets. This could challenge the region in a similar fashion to the Greek crisis in 2009. Germany, the commercial engine for the EU, has structural problems to deal with in its automotive sector due to vehicle electrification. Overall, the EU is likely to encounter a mild recession over 2023 as per the UK.

The USA is the last refuge for innovation and growth

Despite weak leadership, high levels of national indebtedness (especially due to Biden's spend, spend, spend policy), we can expect overall economic resilience in the face of near double-digit inflation and spiralling bank rates. The housing market is buffeted due to 30 year fixed mortgages. The Senate and House are split between Republicans and Democrats, reducing any further economic damage by Biden and team. Great efforts are being made to move production onshore from China and elsewhere. The region is largely self-sufficient in energy and raw materials. Industry has enjoyed strong growth in comparison to Europe and will continue to do so, especially in Big tech.

Russia and the continuing Ukraine conflict

Putin is increasingly wedged into a political corner as his military campaign flounders in the Ukraine. He cannot afford to lose the war, nor can the Ukraine afford to comprise over a complete and unconditional withdrawal of Russian troops. The consequences could be terrifying as Putin is mad enough to resort to nuclear weapons. Ukraine is a major source of grain to the emerging markets. This is likely to cause enormous human suffering, combined with extreme climate conditions.

The Chinese virus that keeps on giving

As the primary source of the COVID pandemic (the Wuhan virus), China has consistently caused disruption and deaths throughout the world. Its belief that it could control the virus nationally by adopting zero-Covid policies is now in tatters as cases rise to multi-millions each day. This is causing disruption to the world's second largest economy and could help stall global GDP growth in 2023. It also undermines any confidence in autocracies as a stable form of government.

Iran reaches nuclear self-sufficiency

Classed today as a terrorist state by much of the West, Iran continues to pursue its goal of reaching nuclear self-sufficiency in the months ahead. The Geneva talks have broken down due to deliberate Iranian lies and deliberate procrastination. Israel will not tolerate an enemy state armed with nuclear weapons and has launched already several attempts to disrupt the programme. It may resort to all-out war in 2023 to destroy Iran's nuclear facilities.

This will have an impact on energy prices and could trigger massive retaliation by Iran's proxies – Hamas and Hezbollah both of whom are armed with hundreds of thousands of Iranian missiles.

Other areas of the world such as India, Africa and South America may offer investment opportunities for those looking to diversify their portfolios. But in the words of one multi-billion-dollar investor:

“ Why should we look outside the USA when returns there have been so consistently strong? ”

Choosing appropriate asset classes

From an investment viewpoint, the first half of 2023 could be pivotal. Equity markets have fallen rapidly in 2022 and look likely to continue to fall well in to 2023. The question now is how different components of the market might perform as the world continues to experience recession well into 2023 and beyond. In determining an investment strategy, it is necessary to consider trends in each of the main asset classes:

- **Geography** including local prospects for the USA, UK, Europe and Asia (with Japan, India and China as possible separate asset classes)
- **Old economy** including Mega corporations such as the FTSE 100 and S&P 500; as well as small-to-medium corporates as per the FTSE 250
- **New economy** including Big Tech (such as MAAAM); AIM and recent IPOs (such as FinTech in the UK); and Crypto (such as Bitcoin and Ether)
- **Commodities** including food stuffs (e.g., wheat), metals (e.g., gold, silver, copper) and construction materials such as iron ore and concrete.

Investment themes by asset class

Value stocks should remain popular. The new 'FAANG' is Fuel, Agriculture, Aerospace, Nuclear and Gold. Due to the end of cheap money and spiralling inflationary pressures, investors are looking to companies that can comfortably service their debt, deliver strong dividends and maintain or grow equity values. Examples include:

- Defence, boosted by growing spend on arms due to the Russian and Chinese threat (exceeding 2% within the NATO alliance), e.g., Lockheed Martin, Boeing, BAE Systems, Airbus, Rolls Royce
- Mining firms that are cash rich, and produce double digit dividends such as BHP and Rio Tinto
- Consumer staples that can be priced up in line with inflation such as household products and drinks e.g., McDonalds; P&G, Unilever, Diageo, BAT. Luxury goods may also be a shield against inflation such as LVMH
- Pharmaceuticals that continue to benefit from global pandemics, and aging demographics. Healthcare continues to absorb a higher proportion of GDP (now at 10-15% across the globe) e.g., Astra Zeneca, GSK
- Infrastructure, both vendors and operators, that include transportation, construction, and telecommunications (terrestrial and space), e.g., Ferrovial, Verizon, AT&T, Comcast
- Renewable energy and broader ESG stocks that respond to climate change challenges – especially prevalent in 2022. Schroder and Guinness Global Energy funds.

Growth stocks (Mega-tech and small/scale-ups) have taken a beating in 2022 due to the end of cheap money (especially within scale-ups) and inflation (reducing net present value of anticipated future earnings). However, Mega-Tech has been more resilient with strong prospects for Apple, Alphabet, Amazon and Microsoft (part of MAAAM grouping). It may be noted that one size doesn't fit all with Meta (Facebook) and Alphabet (Google) heavily dependent on advertising spend (which is declining as recession sets in).

It would be unwise to expect many of the smaller tech stocks to rebound in 2023 given lack of investment cash and tightening in corporate spend. The most effective way to catch the Tech upswing is to invest in funds such as Allianz Technology, AXA Framlington, Scottish Mortgage and Polar Capital, all of whom have been heavily discounted this year (Scottish Mortgage was down 50% mid 2022).

Arranging an investment portfolio for 2023

Here is a possible reallocation of assets for 2023. See Table 3 below.

Table 3 – Suggested asset allocation for 2023

Asset Class	2022 allocation	2023 allocation	Rational
Liquid assets (cash, fixed rate Bonds)	15%	25%	Stay ready for any market corrections
Old Economy (e.g., FTSE 100)	25%	25%	Exploit value opportunities
Tech stocks	25%	15%	Recovery prospects
Asia/China/India	20%	10%	Diversification
Global funds	15%	20%	Search for income
ESG/Ethical	5%	5%	Follow rising sentiment
Crypto	0%	0%	Await upswing

The implications include:

- Retain a high level of cash (25%) due to market uncertainties – but remember that inflation will bite heavily into this asset class. Fixed rate one-year bonds at 4% can help here. Some cash can be deployed mid-year as the picture for 2023/2024 becomes a little clearer
- Load the portfolio with value stocks (around 50%) by adopting Global funds, and FTSE, S&P ETFs. This should provide some growth in equity value together with strong dividend flows. We can expect global funds to focus on value rather than growth
- Maintain a hold in Asia but defer further investment in China until the country sorts out its economic and political issues. Recent raids on Tech such as Alibaba and Tencent have been damaging to investors. India could be a safer bet
- Tread carefully with Tech (at 15%), preferring to focus on MAAAM stocks rather than start-ups and scale-ups. Prepare to ride the recovery in the NASDAQ and AIM markets but don't expect any substantial advances in 2023. Avoid Crypto for the moment.

Conclusions

2022 was a tough year for investors with contraction in nearly all asset classes. We can expect the bear market to persist for 6-12 further months as governments grapple with inflation and the world experiences a mild recession (2% rather than 4-5% reduction in GDP).

Remembering the adage that each recession holds the seeds for the next recovery, long term investment strategies (5-10 year) should be the only sensible option to ride out the current storm and enjoy returns of 6% plus over time (this has been the average return for equities during the last 25 years).

A combination of ETFs in more mature and well researched equity markets such as the USA, and best-in-class fund managers in more opaque regions such as ASIA could be a preferred route for 2023.



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A pioneer of today's Internet as an ARPA research fellow at MIT in the seventies, Roger has spent over forty five years helping corporations harness the power of new technologies such as cloud, mobile communications, e-commerce, voice recognition and satellite. He was a partner at EY responsible for e-commerce during the dot.com boom. He is a graduate of Cambridge University and MIT, and a visiting professor at the University of Surrey.

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