ALPHA SOURCES

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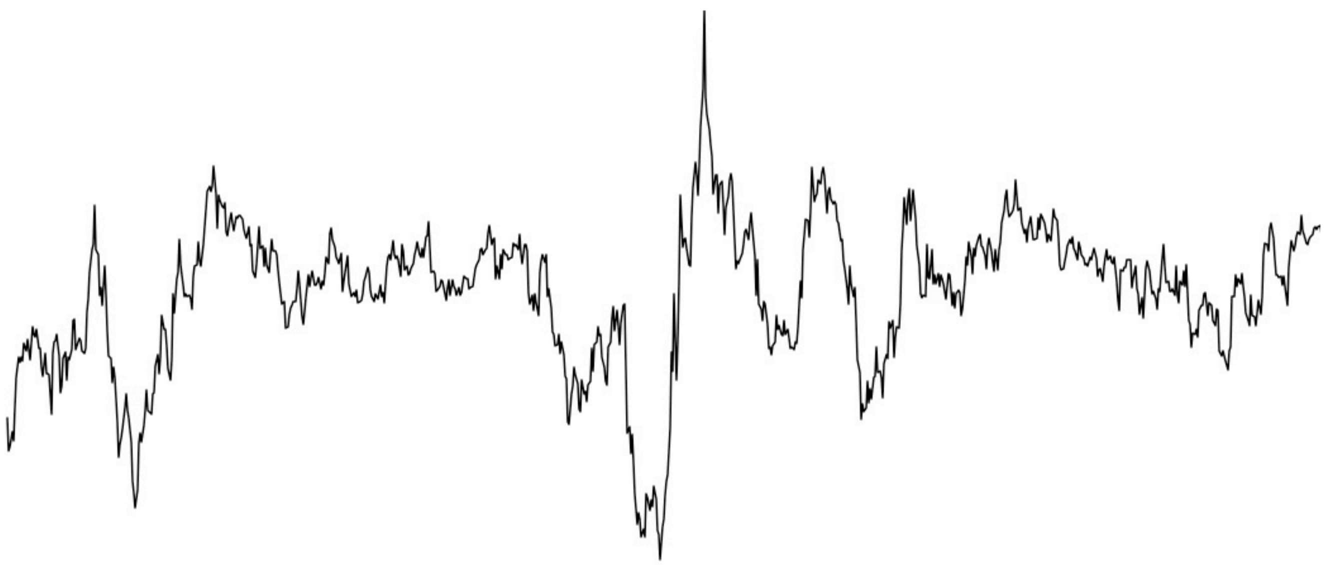

FIVE QUESTIONS FOR 2023

In my day-job I am forced to write my economic outlook for the new year in December, alongside most other economists. This is part of a long-standing sell-side tradition, and at Christmas time, you don't change traditions. The real way to do it, however, is to way a few weeks into January to see where the dust settles and how investors vote with their money in the early sessions of the year. I thus present the Alpha Sources version; five key questions for 2023, and as many answers. I'll start with the war in Russia, asking what in fact Russia will achieve, if anything. I then ask whether 60/40 portfolio will rebound in 2023, and whether the leadership in global equities is changing. I then qualify my answer with a question on geopolitics and the free flow of goods and capital between China and the US, before asking whether Covid is over.

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Q: WHAT DOES 100,000+ LIVES, AND A BUSTED-UP MILITARY, BUY YOU?

A: NOT A WHOLE LOT, IT SEEMS.

According to the sources I have been able to dig out, Russia has lost 100-to-125k soldiers in Ukraine to date, with the estimate of wounded running from just under 100K to more than 300K. I won't even attempt to offer a number on the amount of tanks, helicopters, artillery pieces and armored vehicles that Russia has lost to Ukrainian action, or simply left behind as the front-lines have shifted. But this too is a big number, a very big number. These data will be sober reading in Moscow, in their own right, but mainly because it has little to show for it. In the early days of the invasion, everyone thought that Mr. Putin would be dining in the Ukrainian presidential palace within days. But Ukraine dug deep, and with a steady infusion of western military aid—of increasingly potent nature—Russia has been pushed back to areas it had put its marker on prior to the invasion—with no international recognition, mind—and even beyond. The West is now supplying Ukraine with even heavier armor—free the Leopards—which I suspect is an effort to better equip Ukraine with the ability to continue its counter-offensive in spring. Judging by the success of Ukraine's offensive so far, without the aid that is now on the way, even Crimea is up for grabs, if Washington allows it.

Russia could end up losing everything, snatching defeat from the jaws of victory. This is a silver lining in a world otherwise shocked by the reality of a full-scale war in Europe, something which we had all hoped wouldn't happen in our lifetimes, or in our children's for that matter. As such, one metric upon which to judge the post-1989 rules-based global system, and the associated peace-dividend, is the extent to which such a system can impose costs on anyone trying to break the rules. I think it is fair to say that this rules-bases system is currently imposing a significant cost on Russia.

This point will invite one key criticism, namely that these rules are written in Washington and Europe's capitals, which is exactly the system that Moscow opposes, and which has failed to include Russia. That's true, but this also speaks to the disastrous and costly mistake made by Mr. Putin. If you are going to use brute force to subdue a neighbour, and in so doing expose what you believe is a flawed global system, it is a good idea if you a) do not underestimate your opponent and b) make sure that you have other countries on your side. Russia have failed on both. The lessons from military defeats to Finland and Afghanistan have been forgotten, or never learned, and as far as friends, even China—which Russia is counting on in the more general face-off against the US—has been left scratching its head, pondering what Mr. Putin is trying to achieve.

Of course, Russia is not the only country counting the costs of Mr. Putin's disastrous adventure. Ukraine is suffering more than anyone. Europe more generally is in trouble too, and faces a limited number of choices, all of which could easily end up with bad equilibriums. The risk of a geopolitical race to the bottom which ends with Europe having to pay several trillions of euro to rebuild Ukraine all the while having to stare down an embar-

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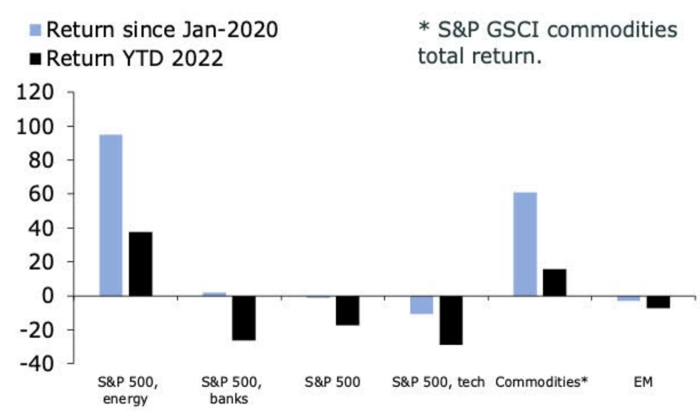
rassed, angry and wounded Russia clutching and caressing its nuclear arsenal is real, and quite frankly, terrifying. In the meantime, however, the main question for 2023 has to be what Russia will have to show for its efforts once the year is over? As Ukraine is trying to drum support in the west for its spring offensive, the answer seems to be; not a whole lot.

Q: WILL THE 60/40 PORTFOLIO REBOUND IN 2023?

A: I THINK SO.

Last year was a grim year for the proverbial diversified investor. According to some charts, last year's terrible performance for 60/40 portfolio was the worst this side of the First World War, or at least since 1929. On my calculations, using the TY1 futures index and the S&P 500, the 60/40 portfolio suffered an 18% loss in 2022, ex-dividends. That's not pretty. It's important to put this denouement into context. It is partly the mirror image of the surge in asset prices during Covid, once central banks and government opened the spigots, even as economic activity all but ceased. As we look into 2023, the sil-

ch. 01 / Better times ahead for 60/40? - **ch. 02** / Who will lead in 2023?



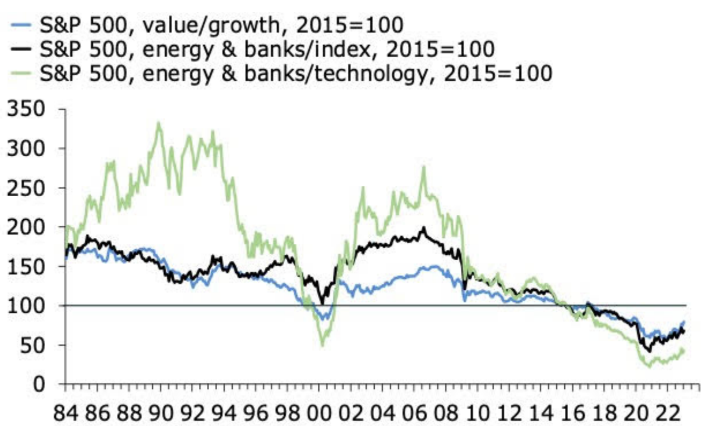
ver lining for investors is that mean reversion is a powerful force in finance, which raises the prospect of a rebound in the fortunes for the 60/40 portfolio this year. I think this is a good bet. The chart below shows that the six-month change in my 60/40 index has bottomed, which is a good first sign for those hoping for a rebound. Ten-year yields appear to be peaking—as inflation fears have eased —and while equities are bound to suffer a further fall in earnings, I am betting that most of the macro pain will be priced-in by the middle of the year.

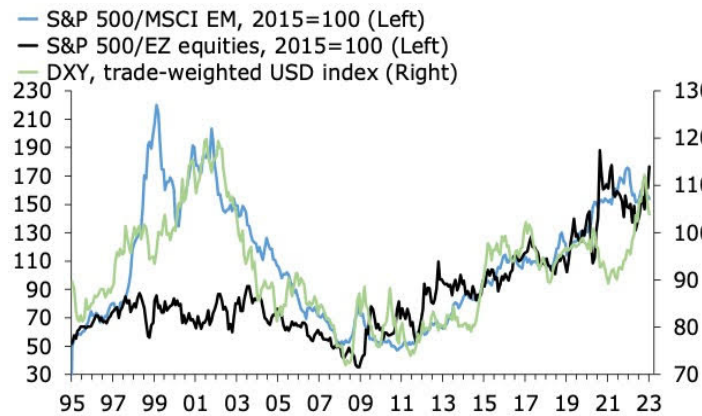
Q: IS THE LEADERSHIP IN EQUITIES CHANGING?

A: IT LOOKS LIKE IT

The broad-based misery heaped investors wasn't the only interesting, albeit depressing, story in 2022. The fall from grace of the otherwise all-dominating growth-factor in equities—dominated by large cap U.S. tech—stands out too. In 2022, this shift was dominated by a rotation from to growth to value—in particular energy—and early 2023 price action suggest that US equities are now trailing the rest of the world more

ch. 03 /Still room to run - **ch. 04** / s US dominance reversing in 2023?





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generally. This raises the prospect of a double-whammy for the (US) growth factor. Last year, they were sold as investors allocated to value, and in 2023 they will be sold as investors sell the US more generally. Citigroup have been out early with the recommendation to move US equities to underweight, and more recently BoFA Hartnett added to the narrative with his suggestion, presumably to US biased investors, to "Buy the World". For the record, I run a MinVar portfolio of large cap US equities, with a forced 20% allocation to banks and energy to capture the value factor, and I have just supplemented with an investment in EZ, Asia and LatAm ETFs, so I have skin in the game here. Was this the right decision? Judging by the price action in the first few sessions of the year, the answer is yes, but it is still early days. More generally, the question of underperformance of US equities chimes with the question of whether the underlying macro-environment post-Covid has changed—primarily towards a sustained rise in interest rates and inflation—in a such a way as to penalise the growth factor, which has been the primary driving force os US equity supremacy. It is difficult to tell at this point, but it looks like it.

Q: WILL GEOPOLITICS COLLIDE WITH CAPITAL MOBILITY IN CHINESE/EM ASSETS?

A: PROBABLY NOT, BUT IT’S A RISK.

The allure of riding the wave of mean-reverting U.S. equity outperformance is of checked by geopolitics. All we have to do is to consider how quickly anyone with assets in Russia had to write down their investments in the country after the war in

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Ukraine broke out. Now imagine, investors and private having to do the same with their investments in China. The only plausible way that this happens "overnight" is if China decides to invade Taiwan, which I doubt will happen this year. But more generally, there is a glaring paradox between calls for investors to diversify into Chinese assets more broadly, and the sustained shift in the way U.S. and Chinese politicians narrate the bilateral relationship between their two countries. Remember in this context that unless you make some very idiosyncratic choices in your portfolio, following the advice to allocate to non-US equities is very difficult to do without a sizeable investment in China, or at the very least countries with a very high beta to China. Europe, as ever, is caught in the middle of any cooling relationship, if not outright conflict, between the US and China. The region is currently outperforming, due mainly to warm weather easing the energy crunch, but the reality remains sobering. Containing Mr. Putin in Ukraine and securing enough LNG supply to make through next winter critically depend on U.S. weapons and energy. As such, while rotating portfolios in favour of non-US equities makes sense from a hole host of relative valuation metrics, it is also a case of picking up dimes in front of the proverbial steamroller. Will investors get steamrolled in 2023? Probably not, but it’s a risk.

Q: IS COVID OVER?

A: YES.

I should specify my question here; to the extent that Covid has been an economy-crippling phenomenon—via lockdowns or

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otherwise—coupled with significant restrictions' the movement and action of people, yes I think it is over. I think we are currently seeing the last gasps of Covid-economics in China, which should be over by Q2, I hope. The risk to this call is straightforward. A new super-variant could emerge, swamping hospitals and scaring politicians, but I doubt it. More generally, of course, Covid is here to stay, putting a burden on healthcare systems along the lines of the flu. It is difficult to quantify the cost of this, but I don't it is something investors will have to pay particular attention to in 2023, or in 2024 for that matter.

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