ASCALON CAPITAL

Focus on the fundamentals

Medium-Term Global Outlook 2023

Important Information

Each year we prepare Our Medium-term Outlook. This is our attempt to make sense of major themes that could dominate economies and markets over the next five years. This medium-term focus is deliberate. It reflects our focus on investing over the medium-term. This means our efforts do not get overly hooked on near-term problems and that is important in removing the temptation to over-trade our portfolios or chase returns.

There is no doubt that 2022 was a challenging year for medium-term investors, us included. Both equities and bonds delivered negative returns. While we managed to mitigate some of the downside, positive returns were difficult to achieve.

Nonetheless, we think it remains important to stay focused on timeframes that reflect our investment process and our investors' investment horizon. In our 2023 Medium-term Outlook, we look at three themes that we think will be critical for investors in coming years. Our medium-term themes have practical implications for portfolio construction. Although sometimes difficult, we have found implementing has helped to deliver improved portfolio resilience.

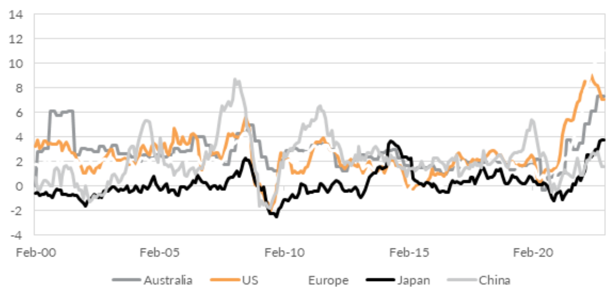
We balance these three themes with two topics that we think will consume a lot of investors' time in the near-term. These are topics that could drive near-term investor uncertainty and market momentum. We hope that by identifying these topics, and providing some concrete metrics to monitor, we can help ourselves and our investors to overcome near-term volatility and remain focused on the outcomes over a longer timeframe.

Year in Review

2022 was the one of the worst years on record for a 60-40 portfolio. Both equities and bonds suffered double digit negative returns – an extremely rare outcome. Global equities plunged 19.5%, while global bond markets felt the wrath of extremely rapid rate hikes with a 16.2% fall. An unclear pathway for interest rate hikes, elevated inflation, the Russia-Ukraine war, and China's Covid lockdowns caused extremely high volatility across all asset markets.

The main story this year has been record-high inflation. Price increases from supply chain disruption coming out of the Covid-19 pandemic was exacerbated by Russia's invasion of Ukraine in early 2022. Robust labour markets and the effects of prolonged loose government policy also pushed prices up on the demand side. While inflation remains elevated, prices have peaked and trended lower in the second half of the year. Goods prices have come off their peak, inflation expectations have collapsed to below the Fed's target, and wages remain anchored.

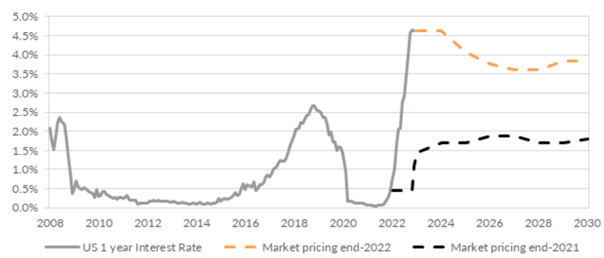
Chart 1: Inflation has soared to decade highs in most developed economies



Source: Bloomberg LP, Oreana

Global central banks began hiking interest rates as inflation started to bite by end-2021. The 'transitory' narrative surrounding inflation was quickly dropped as it became evident in the second half of 2021 that some of these price pressures were more sticky than previously anticipated. The US Federal Reserve hiked rates an astonishing 4.25% in less than 12 months over 2022, including a series of unprecedented 0.75% hikes. The Reserve Bank of Australia also hiked aggressively but shifted to more moderate policies as the effects fed through to the economy. Central bank policy rates in most developed markets were also raised over the year.

Chart 2: Interest rate expectations



Source: Bloomberg LP, Oreana

Dr. Isaac Poole, CIMA®
Executive Director
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Isaac is the CIO for Ascalon Capital. Prior to joining Ascalon Isaac was Global CIO for Oreana Portfolio Advisory. Isaac also worked at Willis Towers Watson as the Head of Capital Markets Research in the Asia-Pacific.

Isaac's focus in this role was delivering asset allocation solutions to improve portfolio outcomes and returns. He is responsible for Ascalon Capital's capital markets research, portfolio construction and asset allocation. Isaac works across Australia and Asia to deliver great investment outcomes to institutional and retail clients.

Isaac has significant experience in the financial sector with a career spanning across central banking, risk management, asset allocation and investment consulting in major firms in Australia, the UK and Hong Kong.

Prior to joining Oreana, Isaac worked at Willis Towers Watson as the Head of Capital Markets Research in the Asia-Pacific. Other prior roles include Chief Economist at NSW Treasury Corporation, and Manager, Economic Risk at Lloyds Banking Group, the largest retail bank in Britain. Isaac started his career at the Reserve Bank of Australia.

Isaac holds a PhD in Economics from the University of Sydney in NSW, Australia. Isaac has also studied at the University of Oxford in the UK and the University of Tasmania in Australia. Isaac is a Certified Investment Management Analyst® holder through the Investment and Wealth InstituteTM

The Russian invasion of Ukraine in February was one of the largest geopolitical shocks in decades. Oil and commodity prices spiked. Europe's high exposure and dependence on Russian energy contributed to an ongoing cost of living crisis and soaring inflation. Many major economies released strategic reserves after sanctions were introduced against Russia. Prices have fallen back well below the spike in March given wavering global demand and recession fears. However, volatility is likely to persist upon further sanctions, the introduction of price caps, China's reopening, and production and demand uncertainty in the current global environment.

Chart 3: Oil prices peaked near USD130/barrel after Russia's invasion in Ukraine

Source: Bloomberg LP, Oreana

The outlier of the year was China. China's economy was in recession for the majority of 2022. Chinese equities collapsed, as the market priced in the recession. The central government stuck staunchly to the draconian measures of the zero-Covid policy as the rest of the world moved on from the pandemic. Cities of millions of residents were locked down abruptly over a handful of cases and Shanghai was strictly shut down for months. The property sector continued to slump and developers struggled with cash flows, exacerbated by waning demand under strict lockdowns. However, the outlook for China has dramatically improved with the sweeping removal of most Covid restrictions in late-2022. Economic recovery, revival of the property sector, and improved foreign relations have become priorities for the central government in 2023.

Market returns in 2022

TABLE 1: ASSET CLASS RETURNS WERE MOSTLY NEGATIVE THROUGH 2022, RESULTING IN WEAK RETURNS OVER 3 AND 5 YEARS.

Asset Class	Index	1 year	3 years	5 years	7 years	10 years
Cash	USTREAS T-Bill Auction Ave 3 Mon	2.1	0.8	1.3	1.1	0.8
Global Bonds	Bloomberg Global Aggregate TR USD	-16.2	-4.5	-1.7	0.1	-0.4
Global Credit	Bloomberg Gbl Agg Credit TR USD	-17.0	-4.0	-1.1	1.0	0.6
Global High Yield	Bloomberg Global High Yield TR USD	-12.7	-1.9	0.4	3.7	3.0
Global Equities	MSCI World PR USD	-19.5	3.3	4.4	6.6	6.9
Global Equities - Small Cap	MSCI World Small Cap PR USD	-20.1	1.5	1.9	5.7	6.6
US Equities	S&P 500 PR	-19.4	5.9	7.5	9.4	10.4
Australian Equities	S&P/ASX 200 PR	-5.5	1.7	3.0	4.1	4.2
Australian Equities - Small Cap	S&P/ASX Small Ordinaries PR AUD	-20.7	-1.2	0.2	3.7	2.0
UK Equities	FTSE 100 PR GBP	0.9	-0.4	-0.6	2.6	2.4
Europe Equities	STOXX Europe 600 PR EUR	-12.9	0.7	1.8	2.2	4.3
Japan Equities	TOPIX PR JPY	-5.1	3.2	0.8	2.9	8.2
China Equities	CSI 300 CNY	-21.6	-1.9	-0.8	0.5	4.4
Hong Kong Equities	Hang Seng HSI PR HKD	-15.5	-11.1	-7.9	-1.5	-1.3
Global Infrastructure	S&P Global Infrastructure PR USD	-3.7	-1.6	0.2	3.4	2.6
Global Real Estate	FTSE EPRA Nareit Developed PR USD	-27.2	-7.5	-3.0	-1.0	0.1

Figure Source: Bloomberg LP, Oreana Portfolio Advisory Service

Three themes for 2023:

Our Medium-term Outlook has a key focus on themes we think will be critical over the medium-term. We think the medium-term is around five years. We look at this period because we expect it will be the length of time required for markets to move to reflect underlying economic fundamentals.

The challenge with this is that market consensus can have a different view of the medium-term. And that can re-price markets in the very near-term. The result is markets that reflect a skewed view of the medium-term fundamentals. These moves can sometimes be material.

In 2022, we observed some key market consensus themes that moved markets. These included a consensus view that

a. Global economies were deglobalizing and that would become a structural trend,

b. Inflation would prove to be sticky above central bank targets for the medium-term,

c. Neutral policy rates would be higher over the medium-term.

These consensus views are challenging because there was limited information available to make a case for the views. Yet markets moved to reflect this consensus by pushing government bond yields materially higher and equity markets materially lower. Asian economies, that have benefited from globalization in the past, were punished.

We disagree with these consensus views. We are not deliberately contrarian investors, but our focus on the medium-term left us skeptical of the market positioning. As we progressed through 2022, we became more comfortable with our views.

Our views through 2022 have helped us identify three key themes that we expect will shape market outcomes in the medium-term. These are:

a. Globalisation is not dead.

b. Elevated debt levels will slow economic growth.

c. We are in a structurally disinflationary world.

This section sets out the issues, our views, and the implications for investors over the medium-term.

1. Globalization is not dead:

The issue: the wake of the Covid19 pandemic resulted in supply chain disruptions, labour shortages, and some increase in protectionism. A broad consensus projected this cyclical trend to be a structural shift that could drive an increase in inflation as production shifted from lower cost emerging economies to be re-shored at higher cost developed economies.

Our view: We wrote in 2022 that we expected globalization to reassert itself. Through 2022 we have seen this to be the case, although it is too early to declare our view correct. Yet the data clearly show that world trade has surged to record highs. It rebounded sharply in 2021 as a percentage of global GDP. And growth rates remain elevated compared with the intra-crisis period post-GFC and pre-pandemic.

We think growth rates could slow. But importantly, we do not expect them to turn negative as they did in the intra-crisis period. The economic incentives for global corporations to source cheap productive capacity and protect margins and earnings in the interest of shareholders will remain compelling.

Economic research indicates that globalization has put some downward pressure on inflation over the past three decades. But estimates of that impact vary from very little, to a modest amount. We suspect the recent bout of inflation has had very little to do with deglobalization and more to do with frozen supply chains because of the pandemic. If globalization persists, or stabilizes, then we expect a disinflationary pressure will persist in the medium-term.

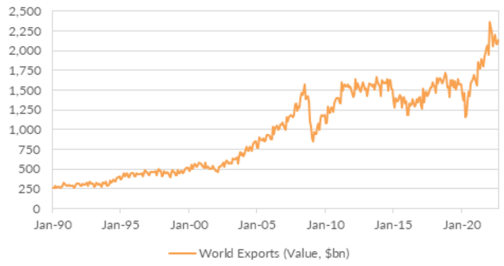
Implications: We see two key implications for a recovery, or even a stabilization, in globalization.

a. Disinflation: If disinflationary pressures persist as we expect, then the recent rate hike cycle from central banks does not precede a period of structurally high policy rates. Instead, we expect there will be limited impact on long-term policy rates. And that means that government bonds with yields meaningfully higher than around 3.00% will continue to look somewhat attractive in the medium-term.

a. Asian growth: We expect lower-cost producers in Asia to continue to be at the epicenter of global supply chains for global conglomerates. Historically that has centered on China, but other countries including Vietnam, India and Indonesia, among others, stand to gain. The pandemic was a challenging period for Asia as China closed its borders and supply chains atrophied. But we expect globalization will reemerge and support Asian economies and markets in the medium-term.

Key Charts:

Chart 4: The value of trade has surged post-pandemic to record high values.



Source: Bloomberg LP, Oreana.

Chart 5: Trade openness (trade as a percent of world GDP) recovered in 2021.

Source: Bloomberg LP, Oreana.

Chart 6: Shipping container volumes have slowed in 2022, but stabilized as prices fell through Q4.

Source: Kiel Institute for the World Economy, Oreana.

2. Elevated debt levels will slow economic growth:

The issue: Global debt surged in 2020 as governments implemented far-reaching fiscal support through the pandemic. Corporate debt similarly surged as companies took advantage of low or negative rates to term out their corporate bond profile. Households, buoyed by pandemic handouts, similarly spent up, increasing their debt burdens. While inflation has helped reduce debt as a percentage of GDP in 2022, hefty debt burden remains a critical issue for the medium-term economic outlook.

Our view: We think US corporate debt remains a focal point for US recessionary risk in the medium-term. Elevated levels of household debt could exacerbate any recession that does take place. The US government is less likely to step in with significant fiscal support if a recession does occur, meaning that any recession in the medium-term is not likely to be particularly short, nor shallow.

Major corporate debt maturities have been termed out to 2024 and beyond. That means that US companies in particular are likely to be resilient to higher Fed Funds rates, at least through 2023. But the refinancing requirements in 2024 could place a burden on the US credit market. This is particularly true as credit quality has deteriorated over the past decade. The majority of the US investment grade corporate debt on issue is rated the lowest rating that can still be considered investment grade.

A credit crunch for corporates would result in significant damage to household incomes. This would be challenging for household balance sheets that have burned through excess savings and added to debt levels in the post-pandemic era. We expect central banks will be left to do the heavy lifting to soften any recession that does occur. The run-up in government debt as a result of fiscal largesse during the pandemic is unlikely to be replicated again.

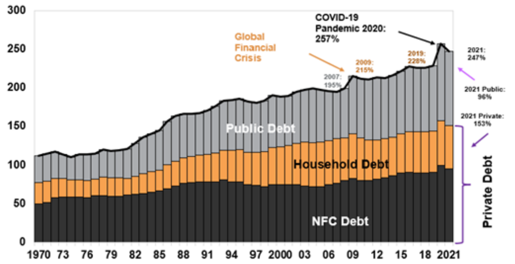
Implications: We see two key implications that arise from the elevated debt levels across the economy.

a. Increased recessionary risk: Higher interest rates pose a risk to indebted households and the private sector. We think this risk will grow over the medium-term. As policy rates are left at restrictive levels for an extended period, the risk of recession will increase. In the near-term, we expect to see a retrenchment in household and corporate spending that will slow economic and employment growth, and sharply reduce inflation. That will compress earnings – but we think this was largely priced in through 2022.

b. Fixed income decisions will be critical: We expect government bonds will be an important part of a diversified portfolio over the medium-term as recessionary risks increase. For most investors, government bonds are the best downside protection on offer against this outcome. Investment grade corporate credit will not offer the same protection – although it may offer better returns in the period preceding recession. We think it is important to distinguish between the different assets, understand their role, and allocate appropriately over the medium-term.

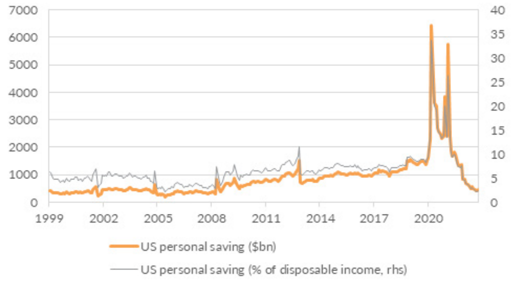
Key Charts:

Chart 7: Global debt surged through the pandemic, and remains nears historic highs.



Source: IMF Global Debt Database 2022.

Chart 8: Consumers are burning through their savings and saving less.



Source: Bloomberg LP, Oreana.

3. We are in a structurally disinflationary world:

The issue: Inflation in the US peaked at 9.1% in June 2022. Core PCE inflation, the Fed's preferred measure, peaked earlier in Feb 2022. There is now a consensus view that inflation will remain persistently high and challenge central bank targets. The arguments for persistent inflation include deglobalization, labour shortages and the impact of the war in Ukraine. Concerns about persistently high inflation have led to discussion about changing central bank targets, and the need for higher policy rates for a much longer period of time.

Our view: We think inflation will fall quite quickly in 2023 with a meaningfully high probability (i.e 50-80%) that inflation undershoots the US Federal Reserve's 2.00% target over the medium-term. We think there is a small, but not trivial probability (ie. around 10%) that inflation slows to below the Fed's target by end-2023.

Central banks, led by the Fed, have hiked policy rates aggressively through 2022, even as inflation slowed. Global supply chains have reopened, inflation expectations have remained very well anchored, and there is no wage-price spiral evident. Households in the US have burned through their excess savings and that will translate to slower demand. The US housing market has collapsed. Core PCE inflation has slowed rapidly through Q4 2022.

From a medium-term perspective, we continue to expect debt, demographics and globalization to exert disinflationary pressure on the global economy. That is, the structural disinflationary impact that persisted in the intra-crisis period will persist, while the inflationary period of 2021-2022 will be eventually recognised by investors as cyclical in nature.

Implications: We see two important implications for investors stemming from structural disinflationary pressures over the medium-term.

a. Yields will revert lower: Government bond yields around the world surged higher with cyclical inflation. This reflected both a widening term and inflation premium as well as markets priced in higher central bank policy rates. At these levels, government bond yields provided a good combination of income, downside protection and diversification. We expect government yields will decline over the medium-term as disinflation reasserts itself.

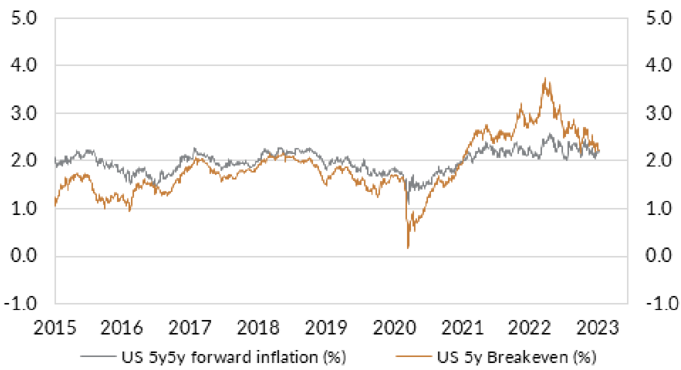
b. Recession risks are elevated: The US Fed and other central banks including the Reserve Bank of Australia have hiked policy rates in response to cyclical inflation. This has been appropriate. But we expect structural disinflationary pressures to push inflation lower, sooner than central banks appear to expect. This leaves an elevated risk of recession over the medium-term. The timing of the recession could be delayed if central banks hike less than markets currently expect.

Key Charts:

Chart 9: Headline and core PCE inflation peaked in early 2022 and is trending lower.

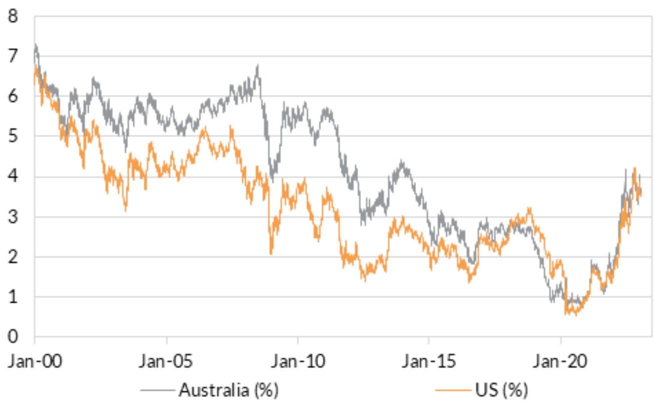
Source: Bloomberg LP, Oreana.

Chart 10: Market implied inflation expectations are well anchored in line with Fed targets around 2.0%.

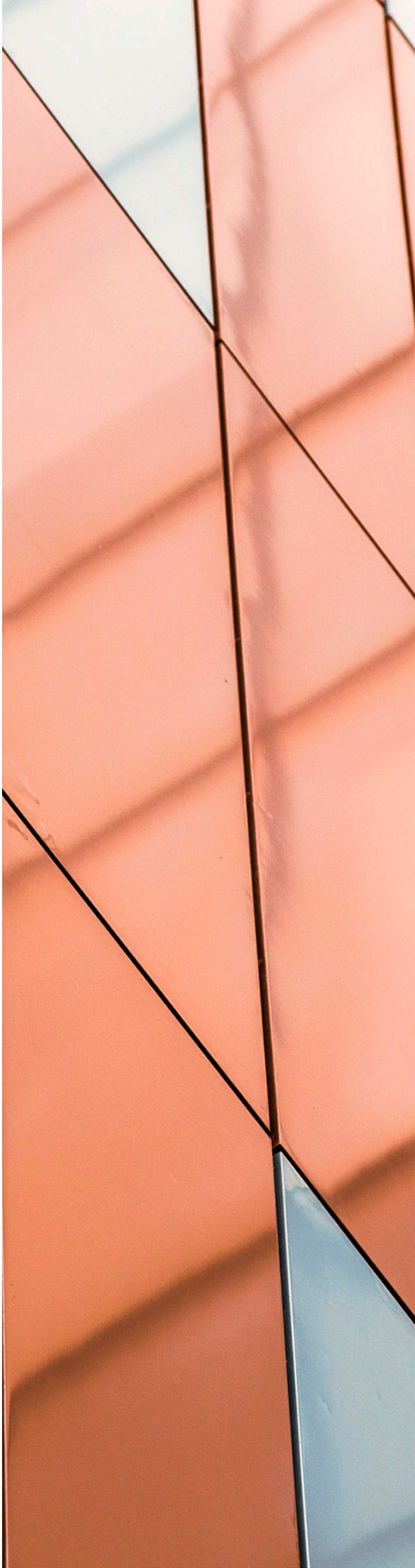


Source: Bloomberg LP, Oreana.

Chart 11: Australian and US government bond yields are elevated relative to recent history and provide attractive income and downside protection



Source: Bloomberg LP, Oreana.



Two topics for 2023:

Our key focus is on themes that will shape market outcomes over the medium-term. But we know that market consensus can get caught up in short-term topics. These topics can tend to drag market movements away from the economic fundamentals. These moves can sometimes be material.

In 2022, we observed two key topics that moved markets. These included a consensus view that

a. The US would enter recession in early 2023, and

b. China is uninvestable.

Markets moved to reflect this consensus by pushing government bond yields materially higher and equity markets materially lower, and by punishing Chinese and Asian equity markets.

We disagreed with these consensus views through 2022. But we took steps to mitigate the impact of our contrarian views on our portfolios. As we progressed through 2022, we became more comfortable with our views. Importantly, markets moved much closer to reflect our view of the world in Q4 2022.

As we enter 2023, we think it is useful to set out our view on the two key topics that we think will shape 2023. These topics are:

a. The Fed will probably not cause a recession this year, and

b. China is not uninvestable.

It is important for us to point out that we are not short-term investors. We are not forecasting near-term outcomes. But being aware of the risks and opportunities over the coming 12 months will help us, and other investors, better navigate the near-term as we continue to focus on medium-term outcomes.

This section sets out our views, the risks, and the implications for investors over the near-term.

1. The Fed will probably not cause a recession this year.

US economic data are slowing rapidly. The housing market is in free fall. The manufacturing and services sectors are contracting. Wages growth has slowed. Core inflation has peaked and is slowing quicker than most investors and central banks had anticipated. Inflation expectations point to the Fed missing its inflation target on the low side over the next decade.

But the Fed insists it will need to hike further and hold rates at restrictive levels for longer than the market currently anticipates. Unfortunately, the Fed has limited credibility in rates markets right now. And data are screaming at the Fed to pause sooner rather than later.

We expect the Fed will pause in Q1 2023. Rates are likely to remain at those restrictive levels for some time. Potentially for 12 months. The Fed will probably not cause a recession this year if the Fed listens to the data and pauses.

A pause in early 2023 will be a positive outcome for equity and bond markets in the near-term. We expect this could be supportive of developed market equities including the US and Australia.

Risks: We remain aware of the risk from recession. The inverted yield curve – the difference between the 10-year US Treasury yield and the 2-year US Treasury yield – has historically preceded US recessions. Picking a recession timing is difficult. If the Fed hikes too far, they could cause a recession in early 2023.

We think the best signpost for the timing of a recession will be a focus on shorter-dated US Treasury yields. Historically, a collapse in the 2-year yield that normalizes the yield curve – moves it from negative to positive – is a good indication that recession is imminent.

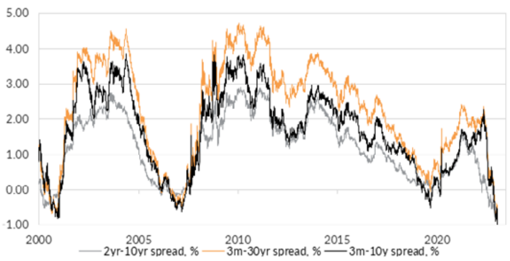
Implications: The sequencing of these potential outcomes presents challenges from an investment perspective. We make the following observations.

a. Government bonds look attractive: Yields remain relatively elevated in our view. We think high quality government bond yields – US Treasuries and Australian Government bonds in particular – offer an attractive downside protection, income and diversification benefit through 2023.

b. Remain near strategic asset allocation weights in developed market equities: The near-term outlook for equities depends crucially on the Fed's monetary policy decisions. We expect there could be more upside. But risk is skewed to the downside over the medium-term, leaving us at a neutral setting for equities.

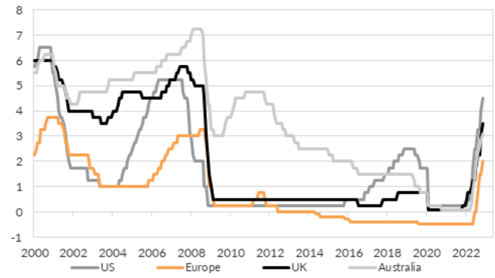
Key Charts:

Chart 12: The yield curve is deeply inverted across the US yield curve, and that has always preceded recession.



Source: Bloomberg LP, Oreana

Chart 13: Global central banks, led by the Fed, hiked rates aggressively and may pause early in 2023, extending the economic cycle.



Source: Bloomberg LP, Oreana.

2. China is not uninvestable.

China experienced its own recession through most of 2022. Through 2022, China was seen as "uninvestable" by some foreign investors. Investors faced regulatory challenges, zero-Covid lockdowns, a National Congress and ongoing atrophy in the housing sector. But China's economy began to reopen in October. By December, the reopening was clear to see. As we begin 2023, that reopening has some way to go and will continue to be supported by fiscal policy and regulatory support.

We expect the real story for investors will be pent up demand from mainland households. That will show itself in increased tourism, increased domestic demand, and a support to global growth. We expect China's reopening will be especially positive for Asian economies. A good bellwether for Chinese demand will be HK tourism from mainland China.

Risks: China's abrupt shift to reopening caught many by surprise – despite the clear signals that began in October 2022. There is no guarantee that China will not reintroduce lockdowns or restrictions. Furthermore, China's households may choose not to resume spending and traveling in line with pre-Covid trends.

Globally, China poses geopolitical challenges to risk appetite. We expect China will continue to pursue its own interests and that could place it at loggerheads with some developed markets, particularly the US. Furthermore, the reopening could result in China exporting inflationary pressures to the rest of the world, causing developed market central banks to hike rate even further that is necessary to control domestic inflation.

Implications: China's recovery and rebound from recession provide upside risks to global equities. However, there are also important implications for bond yields.

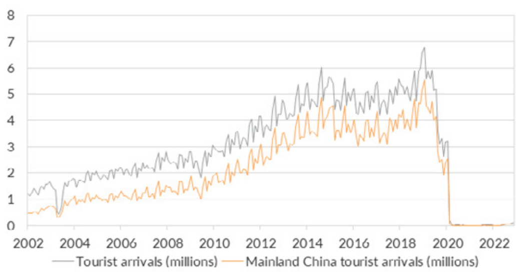
1. **Asian equities could be an important source of alpha: China equities and Hong Kong equities had already rebounded sharply by January 2023 from their October troughs. We expect there could be more upside as China exits its recession, supporting growth throughout the Asian region.**

2. **Australia should benefit: Australia's equities outperformed global counterparts through 2022. We expect that trend to continue through 2023. That will be supported by a less aggressive central bank, but importantly, the resumption of trade in key goods with a reopening China.**

3. **Inflation remains an uncertainty: Inflation peaked in the US in early 2022. But China's reopening poses a near-term threat to inflation. We are not sure if China will export inflation or disinflation pressures globally. But at the margin, we lean toward China exporting some inflationary pressure. We think that will be a positive, as it will reduce the risk of outright deflation through 2023 in the US, and may help delay a recession.**

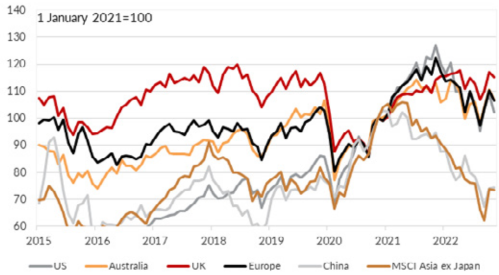
Key Charts:

Chart 14: HK tourist arrivals from China will be a key bellwether for Chinese demand through 2023.



Source: Bloomberg LP, Oreana

Chart 15: China's equity markets underperformance recovered in Q4 2022 and could improve further through 2023.



Source: Bloomberg LP, Oreana

Conclusion

2022 was a historically bad year for multi-asset investors. The rapid repricing of interest rate expectations in the wake of elevated inflation resulted in a painful shake out for investors in bonds and equities. Global investors shifted to a bearish consensus on the economic outlook that included a recession in early 2023.

We think risks for investors remain elevated over the medium-term. But in this Medium-term Outlook, we have pushed back against some of the key themes that we think have been driving markets. We think globalization and debt dynamics will leave investors facing a disinflationary environment for some time. That means growth and interest rates are likely to remain slow and low over the medium-term. In the near-term, credit risk remains elevated although that may be a story for 2024 or 2025, rather than 2023. Finally, China and Asia remain an important part of the global investment landscape, despite many Western analysts declaring it "uninvestable" in 2022.

Our 2023 Medium-term Outlook contains key themes and topics that investors can use to build resilience in their portfolios over the medium-term. We acknowledge that implementing some or all of the recommendations can be difficult. But we continue to believe that efforts to reflect and respect these themes and topics will prove to be beneficial to portfolios over the medium-term.

For further information, please contact Ascalon

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About Ascalon

Ascalon delivers institutional grade investment and portfolio management solutions for clients across Asia and Australia.

The team have extensive experience providing investment services to retail and high net worth clients, family offices and institutional investors.

Ascalon employs a flexible, comprehensive framework and repeatable processes. Our solutions are backed by expertise and thought leadership across the entire investment process.

Our broad range of solutions include:

Managed accounts

We have a range of Separately Managed Accounts (SMAs) and Managed Discretionary Accounts (MDAs) available in Australia and Hong Kong across a range of investment platforms. These have delivered strong risk-adjusted returns for our clients through a challenging investment period.

Investment governance

We are thought leaders and experts in investment governance and best practice stewardship. Ascalon provides investment governance reviews, investment committee documentation and can participate in investment committees.

Advisory solutions

Our broad expertise and institutional background mean we can provide a range of bespoke advisory solutions for clients. This includes portfolio construction and asset allocation, stress testing and scenario analysis, communications and capital market research, and Approved Product List management.

Manager research

Our team has decades of experience across Australia, Asia and the globe providing research, advice, and portfolio construction. The Ascalon team can leverage this to provide strategy review and recommendations across a wide range of asset classes.

Ascalon provides governance, expertise, and clear, efficient investment solutions with its powerful investment engine. We align ourselves with your investment needs and objectives. We aim to be your trusted partner through your investing journey.

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