BOV ASSET MANAGEMENT

A MEMBER OF THE BOV GROUP

2022 marked a year where financial markets were challenged by an aggressive and synchronised monetary policy tightening. Russia's invasion in Ukraine fuelled geopolitical tensions and higher energy prices. The increased inflation risk led to a strong adjustment to higher interest rates across the globe. Tightening of financial conditions, as well as China's strict adherence to zero-Covid-19 policies also added economic growth concerns to financial markets. Both fixed income and equity markets closed the year down by double digits, as valuations declined and diversification ability across asset classes disappeared.

While signs of peak inflation have emerged, a confirmation of disinflation trends and peak central bank hawkishness is needed to sustain a shift in market sentiment. Until then, economic, geopolitical and monetary policy uncertainty is expected to keep financial markets volatile over the coming months. We see 2023 to be a challenging year from a fundamental point of view and stay defensively positioned, shifting our preference to investment grade over high yield and equity markets.

The key main drivers for 2023 are:

- ***Fighting inflation at the cost of a recession***

  Inflation proved more persistent than initially expected, with 2022 characterised by a string of upward surprises to inflation. While signs of disinflation ignite cautious optimism, central banks have communicated their commitment to remain hawkish as much as it takes to restore price stability, even while forecasting a slowdown in economic growth. With December marking the first step down in the size of rate hikes, the main questions for the year are at what level will interest rates peak and for how long it will remain at level. The state of the labour market is the key driver for inflation outlook in 2023, with wage inflation and job gains as key data points for understanding how much further interest rates must rise to bring balance back to labour markets.

- ***Lower economic growth means lower profit margins***

  With hopes for disinflation comes concerns for economic growth. Economies not only face the pressure of rising prices but also the cost of higher interest rates. This has led to downgrades in the outlook for 2023. The International Monetary Fund forecasts global growth to slow to 2.7 percent and expects one third of the world economy to be in recession in 2023. For companies, this means that earnings outlook has also deteriorated. Leading economic indicators support this view, with Purchasing Manager Indices at contraction levels, and business confidence declining. With input costs still high and demand outlook worsening, profit margins are expected to fall further in 2023.

- ***Energy driven recession in Europe***

  With global growth expected to decelerate, a divergence in regional economic performances is also expected over the coming months. The US economy is heading into a period of slower growth on the back of a strong labour market and resilient households spending. Growth policy dynamics for Europe, on the other hand are weaker. Europe is expected to experience a deeper recession, driven by the energy crisis. Concerns over energy supply, higher prices, and support measures to ease the price burden are added headwinds for Europe. So far, efforts to conserve energy and warm winter temperatures have lowered heating demand below the ten-year average, and eased

energy prices, as well as concerns. However, colder weather and maintaining sufficient inventory levels for next winter, remain key risks for the region.

- ***China's post pandemic economic path***

China's announcement of its faster pace exit from its zero covid-19 policy brings forward a higher expected level of mobility and a stronger economic growth forecast for 2023. The significant disruptions from a fresh wave of covid-19 infections as the country reopens is expected to be short-lived. Together with the pro-growth stance, government's measures to navigate the housing property crisis, and commitment to boost confidence, supports an improved outlook for China in 2023. Key government priorities include expanding domestic demand through consumer spending, and reviving confidence and foreign direct investment, following last year's regulatory crackdown.

- ***Lingering Geopolitics Risks***

The ongoing war between Russia and Ukraine is a known risk but with an unknown outcome. The direction to this conflict, that shows no end in sight, is likely to effect market sentiment, particularly for European equities. Other geopolitical risks, including the flaring up of US China tensions over Taiwan, also remind us that geopolitical risks and their uncertainty, will be carried forward into the new year.

EQUITIES

2022 marked a volatile year for global equity markets. The combination of inflation, hawkish central banks and a slowing economic environment led to the worst yearly performance since 2008. Overall, growth stocks underperformed value sectors. The energy sector was the only exception to the negative returns, surging by 41% on higher energy prices arising from Russia's invasion in Ukraine.

Inflation pressures and an aggressive pace of monetary tightening brought about a sharp shift in real rates and a decline in price to earnings multiples, while earnings stayed resilient. The United States (US) and European equity indices closed the year trading at a forward price to earnings multiple of 16.8x and 12.4x, respectively. While US equities still trade closer to the ten-year average of 17.3x, European equities trade at a discount when compared to a ten-year average multiple of 14.5x.

Looking ahead, the main consideration for equities in 2023 is the impact of higher interest rates on growth. With central banks fighting inflation with higher rates, the cost of tighter financial conditions is a period of below trend growth. Economic activity has already started to slow over the past months and a recession is widely anticipated in 2023. The International Monetary Fund downgraded 2023 growth outlook to 2.7%, with the US forecasted to grow at 1% and the Euro Area overall at 0.5%.

Weaknesses across leading economic indicators support this view. Purchasing Manager Indices, which provides a direction for economic trends stand below the 50 level, across all major regions: US, Europe, United Kingdom (UK) as well as China. This signals an economic contraction. Similarly, consumer and business confidence has moved lower, as expectations turn cautious. The only remaining positive is the labour market, which remains tight, with unemployment rates in US and Europe at historic lows of 3.7% and 6.5%, respectively.

Earnings growth is expected to be challenging in a year when economies are expected to grow below trend. 2023 is expected to be characterised by a transition from a supply to a demand shock, as consumers react to higher prices and tighter financial conditions. In addition to the weaker demand environment, input costs are expected to remain high, with upside risks from wage inflation. Profit margin compression is likely to be the subsequent result of these economic dynamics.

Going forward, uncertainty is expected to remain high, and we stay defensively positioned across the equity market. On a sector level, we continue to prefer those sectors which have defensive properties in a period of slowing growth. This includes the health care sector, for its inelastic demand and the energy sector which acts as a hedge to ongoing geopolitical risks, particularly in Europe. We have also upgraded our view for the consumer staples and the utilities sector for their earnings stability in a cyclical slowdown. Our least preferred are the real estate, communication services and consumer discretionary sectors.

Notwithstanding our overall cautious stance, we are being selective on opportunities that arise at a company specific level. Companies which hold pricing power, by passing on higher prices with minimal demand elasticity or enjoy strong brand value are expected to outperform. In addition, the recent news flow of China's reopening is expected to not only benefit the region but also support European equities with exposure to the Chinese consumer, as mobility returns to more normalised levels. Throughout the year we expect more opportunities to arise on confirmation of a disinflation trend and peak tightening by central banks, as markets look to price ahead the easing of growth concerns.

FIXED INCOME

Persistently higher inflation numbers and the synchronised aggressive pace of monetary tightening during 2022 has led to a sharp contraction across the bond markets. United States and European Investment Grade Bonds closed the year down circa -17.7% and -14% respectively, an even bigger decline than that the negative return of circa -11.4% and -11.52% recorded across United States and European High Yield Bond markets respectively. United Kingdom Investment Grade Bonds closed the year lower down circa -18.26%.

Markets are expecting a recession in 2023, as signalled by the inverted, risk-free yield curves. As central bank policies have shifted to fighting inflation with tightening financial conditions, markets are focused on a policy pivot. Uncertainty is expected to decrease as central banks shift to a more balanced policy mix focused on growth and inflation while maintaining optionality for future moves, and cost increases become less challenging for corporate planning. However, with employment remaining strong and generally strong consumer balance sheets supported by the fiscal stimulus under COVID, we expect default rates not to spike.

Geopolitical challenges—Ukraine conflict, deglobalization, sustainability—have triggered supply-side disruptions and higher inflation. Recent trends improve the outlook for credit, including signs of moderating U.S. inflation, supply-side relief in Europe and a re-opening in China, with lower energy prices.

The lure of fixed income is strong as surging yields mean bonds finally offer income as well as the potential for protection and capital appreciation. We are overweight core fixed income. Investors are finally getting paid to allocate to fixed income securities by way of higher coupon payments. In the event of broad pressure on earnings and further upside to interest rates, the equity risk premium will compress further, and thereby increase the relative attractiveness of bonds to equities.

We are positive on core fixed income. Despite historically shielding portfolios from recession, longdated bonds face challenges as investors will increasingly ask for more compensation to hold long-term government bonds –or term premium –amid high debt levels, rising supply and higher inflation. As long-dated bonds face challenges we prefer short-term government and municipal bonds for income and longerduration investment-grade corporates with strong balance sheets.

Our current preference for better quality credit within investment grade is supported by the continued uncertainty in relation to inflation and the recession narrative, which is expected to be more shielded to wider spreads, on weaker economic data. Meanwhile, we continue to hold a low to medium portfolio duration, due to the uncertain inflation outlook and upside risks to yields.

LOCAL MARKET

Malta's economy is forecasted to grow by 6.8% for 2022, followed by 3.7% growth in 2023. Malta's growth is one of the highest GDP growth rates in the European Area. The Central Bank of Malta has revised the growth projections, reflecting a more dynamic economic activity, especially in tourism and private consumption. This projected faster recovery during 2022 had led to a downward revaluation of growth in 2023.

Both domestic demand and net exports are expected to contribute to GDP growth. Inflation, which stands above target, is still below most of the countries in the Euro Area countries. This is a result of the fiscal measure that ease prices to provide support to households and companies, by fixing the energy prices. This is viewed that Malta is expected to avoid a recessionary pressure that other countries are facing. The unemployment rate is expected to decrease to 3% during 2022 and is expected to remain around this historically low level throughout the forecasted period.

Risks to economic activity in Malta for 2023 are slightly negative. The main negative contributor to this is the possibility of a greater weakness than that foreseen by the international situation, which could lead to a decrease in exports. Moreover, higher inflation than imported products could have a negative impact on private consumption and corporate investment.

The local equity market's performance has suffered during 2022, and one factor of this negativity in the equity market is due to the lack of dividends by certain local companies when compared to historical dividend returns. Return of dividends after likely positive results for financial year 2022 augurs well for the shareholders. The local corporate bond market is foreseen to continue adjusting to the new interest rate scenario; thus, one must remain cautious on this asset class where spreads versus the MGS market have tightened to very low levels. That said, tapping opportunities in corporate bonds which are attractive from a risk-reward perspective must be key. During the December's Monetary Policy meeting, Christine Lagarde made it clear that financial markets may need to revise their expectations about the future ECB interest rates. In its comments, the ECB was commendably clear that there is no pivot even if the pace of rate hikes slows, with the ECB is expected to continue hiking interest rates in 2023, and for as long as necessary to bring inflation back to the medium-term target of 2%. These decisions will definitely have direct impact on the Maltese Government Stocks, thus it is adequate to have a medium duration at this delicate point in time.

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