INVESTMENT REPORT 2023

THE GREAT REVALUATION: GROWTH OR VALUE ASSETS?

Roger Camrass

CIONET UK

> *“Each recession holds the seeds for the next recovery”*

In this report, Roger Camrass presents his personal views on investment prospects for 2023 with a review of the remaining year (2022). Being responsible for his pension for some thirty years, Roger has followed global markets closely each year and summarises trends in his annual investment reports. There have been few moments in the last thirty years when the investment outlook has been more uncertain. The question today is how to balance investment between growth and value stocks to achieve inflation busting returns (now in double figures across Europe).

Disclaimer: Although all information and opinions expressed in this document were obtained in good faith from sources believed to be reliable, no representation or warranty, express or implied, is made as to its accuracy or completeness. Information, opinions and prices indicated are subject to change without notice. Asset classes, asset allocation and investment instruments are indicative.

Value versus Growth – what do we mean?

The last decade has been the high point for growth stocks during which companies such as Apple and Microsoft have achieved trillion-dollar valuations. Apple alone is worth more than the entire UK equity market. The MAAAM group (Meta, Apple, Alphabet, Amazon and Microsoft) is worth more than the entire European equity market. Big Tech has driven the S&P 500 to new heights, representing 25% of total market value.

Growth and value stocks sit at opposite ends of the investment spectrum. Value stocks tend to make money now via a reliable flow of dividends. Such value stocks include pharma, energy, utilities and banking. Growth stocks such as MAAAM tend to offer the promise of future returns based on the reinvestment of today’s earnings. When inflation and bank rates are low, future earnings can appear to be attractive relative to current ones. When interest and bank rates rise rapidly, the market favours cash today over promises tomorrow.

In this report we examine the current state of global markets and consider an appropriate balance between value and growth stocks. During the first half of 2022, both growth and value stocks have been hit hard with S&P 500 down 21% and NASDAQ down 32% in June. However, July brought temporary relief as markets improved by 17% implying the possibility of a soft landing out of the current recession. How consumers and businesses might cope with exceptional energy and food costs is still a big unknown. Equally, central banks may raise rates aggressively to stave off double digit inflation. Overall, we are left with an unprecedented level of uncertainty.

In my opinion, taking the long term (5-10 year) view is the secret to successful investment strategies – buying progressively into markets over time to even out volatility. As in most situations, diversification is the safest way of protecting one’s investments. Now more than ever, patience and diversification are necessary components of a successful long-term strategy.

Investment Overview

The 2021 Investment report, Lockdown 3.0: *East meets West*[1], took an overly optimistic view of how Asia and especially China would cope with the COVID virus. Having inflicted this virus on the world in the confident belief that it could control its own domestic situation, the reality of 2022 suggests otherwise. Instead, China has had to adopt a zero-covid tolerance policy, with major cities in frequent lockdown, and manufacturing at an all-time low. This is especially significant given the jump in demand for goods post lockdown in the West. In defence of the 2021 report, Asia now represents 60% of global GDP and China envisages a middle class numbering 850 million by 2030. Several Asian countries such as Vietnam and Malaysia are benefiting already from an impending upswing. China will come to the fore in the longer term.

But the current economic position across the West is increasingly precarious. The combination of cheap money, government handouts in the USA and elsewhere, and explosive consumer demand post lock downs in 2020 and 2021 had the effect of propelling equity markets to new highs with Tech benefiting disproportionately from the post covid mini boom. The cracks in this virtuous circle appeared in late 2021 as inflation began to spiral and global supply chains buckled under unprecedented demand. The invasion of the Ukraine by Russia in late February was the final nail in the coffin as energy prices reached record highs and central banks started to raise interest rates to curb inflation (which was heading into double figures in both the USA and Europe)

The UK has had its own problems this year as confidence in Boris Johnson as Prime Minister collapsed, and a new leadership race begun in July. Sterling has declined rapidly against a strong dollar and stands today at £1.17 today (compared to 1.37 in January). However, it has remained relatively stable against the Euro due to an energy crisis on the continent. There are many conflicting views about whether BREXIT has caused structural damage to the UK economy. Recent data shows that UK GDP has remained relatively strong against other G7 countries and our lack of dependence on Russia oil and gas may help protect us from the worst effects of the Ukraine war (as compared to France, Germany and Italy). What is of greatest importance however is the choice of a new prime minister and his/her ability to adopt a radical economic reform plan. The status quo is no longer viable.

Choosing appropriate asset classes

From an investment viewpoint, the second half of 2022 could be pivotal. Equity markets have fallen rapidly in H1 (at one point down 25%) followed by a modest recovery in July. 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 Ethereum).
- Commodities including food stuffs (e.g., wheat), metals (e.g., silver, copper) and construction materials such as iron ore and concrete.

The critical choice today is between growth stocks (both tech and small companies) and value stocks (e.g., the old economy mega-corps and perhaps even mega-tech). It is also about regional diversification. The operating assumption in this report is that we are approaching the market bottom in H2 of 2022 and that year-end should deliver a neutral outcome with S&P climbing back to around 4,400 (from a low of 3,600 in June) and NASDAQ to 14,000 (from a low of 10,600 in June).

Despite two quarters of recession in the USA, we expect relative economic stability there in 2023 which will help support global equity markets (as reflected in MSCI World index). The UK will continue to drift at its current level (the FTSE 100 has not devalued this year due to its strong bias for energy, mining and financial stocks). Europe could be disappointing as high levels of dependence on Russian energy bite hard through the winter.

Looking back on 2021

As countries across the West returned to normality in mid-2021, consumer spending accelerated rapidly to re-pandemic levels. Savings were at an all-time high (over £650 billion in the UK), and consumers were keen to enjoy their newfound freedoms. Cheap money persisted as central banks retained near zero interest rates (negative within the EU at -0.5%). This encouraged venture capitalists to continue to pour money into tech start-ups (over $120 billion during the year) and private equity to rush into the tech sector. IPOs delivered record valuations in the tech sector such as UiPath at close to $40 Billion. Mortgages hovered at around 1-2% in the UK – the lowest level on record. This fuelled a boom in house prices.

As mentioned earlier, the cracks begun to appear in the final quarter of 2021 as equity markets underwent a minor correction during December. Exceptional consumer demand was causing disruptions in global supply chains, and limited capacity in China due to Covid was putting pressure on shop prices. Another important effect was the shortage of silicon chips. This created an inflated market for second hand cars, as new ones were held up due to component shortages. German auto-manufacturing was a casualty, but Tesla was able to insulate itself from such shortages. By year end, Tesla was worth more than the next nine car companies in the world including VW, BMW, GM and Ford.

The build-up of 120,000 Russian troops on the Ukraine border sent alarm signals to governments across the West. NATO began to prepare for a possible invasion and energy prices began to rise. However, most politicians did not believe that Putin would carry out his threats. The world remained relatively calm over Christmas.

Figure 1 illustrates the stock market movements during 2021 and 2022.

Market Index	Final level in 2020	Final level in 2021	Growth in 2021	Decline in 2022 (up to August)	Net change over 2021/22
FTSE 100	6,460	7,384	+14%	0%	+14%
FTSE 250	20,488	23,900	+17%	-20%	-3%
AIM	1,157	1,210	+0.5%	-26%	-25.5%
S&P 500	3,730	4,820	+27%	-13.5%	+13.5%
Dow	30,400	36,585	+20%	-10%	+10%
NASDAQ	12,888	15,832	+23%	-22%	+1%
China SSE	3,473	3,632	+0.5%	-10%	-9.5%
Nikkei	27,444	29,302	+7%	- 3%	+4%
DAX	13,720	16,020	+17%	-17.5%	-0.5%
CAC	5,551	7,217	+30%	-12%	+18%

What is most interesting about the data in Figure 1 is that most equity markets have remained relatively strong over a two-year period despite sharp declines in the first half of 2022. The FTSE and S&P are both up around 14%. Tech has held ground. Only China SSE and UK AIM have incurred substantial losses between January 2021 and August 2022.

Outlook for second half of 2022

Inflation will be the key economic and market determinant for the next eighteen months. Already workers are demanding pay increases of between 6-10% in the UK to help cover rising energy costs and food bills. Mortgage rates could double, and energy prices may reach £4,000-5,000 per household – from earlier levels of £1,500-2,000. Despite these negative sentiments, unemployment remains at record lows of 3.5% in the USA and UK. Again, this contributes to wage inflation as employers face scarcity of labour. This is especially true in the IT sector where CIOs are experiencing a unique war on talent.

Central banks will continue to push rates up to try to contain spiralling inflation. Cheap money has come to an abrupt halt, and this undermines investment in start-ups and scale-ups. Recent IPOs are experiencing dramatic share price reductions of 70-80% as are some established tech firms such as Shopify. The implications of this could be:

- Money seeks safer havens in 'old economy' Mega-stocks such as Pharma, Energy, Mining and Finance. A market premium will be placed on value stocks that are cash rich and able to produce continuing growth in dividends. For example, BHP produces a double-digit dividend. The UK FTSE 100 operates at a 30% discount to other markets causing it to remain flat this year compared to S&P's 13.7% decline (fuelled in part by its dependency on Tech stocks).
- Mega-Tech remains relatively unaffected as this class of asset generates strong profits and holds large cash reserves. Despite a reduction in advertising spend, we might expect MAAAM (Meta, Apple, Amazon, Apple and Microsoft) to enjoy a resurgence in value. This will help the S&P 500 where Tech represented 25% of market value in 2021. It is unlikely that small tech stocks will return to their inflated IPO values given the lack of cheap money and deep discounts due to inflationary pressures
- The more ponderous and uncertain asset class will be small, 'old economy' stocks. As per the FTSE 250, these have been heavily discounted in 2022 on both sides of the Atlantic. Facing a continued recession in 2023, the prospects remain unclear, although some level of revaluation might be anticipated.
- Crypto has taken a severe battering (down 50%) and could reassert itself as the digital economy advances. This is a longer-term prospect.

Geographic divisions

Comparing geographic regions, the USA looks to be the safest bet for the next 18-24 months. The UK may hold water due to its bias towards international markets (especially the FTSE 100) and a strong financial sector (buoyed by higher interest rates). Europe could face economic difficulties due to over dependency on Russian energy and an outmoded industrial base (especially automotive in Germany). Italy remains a festering sore within the EU economic community with debts exceeding 150% of GDP (compared to 100% in UK and 69% in Germany). In summary:

- The USA remains a strong economy due to self-sufficiency in energy and food stuffs. However, aggressive spending by both the Trump and Biden administrations have pushed borrowings up to 137% of GDP and could approach that of Italy in H2 (above 150% of GDP) due to Biden's recent 'Inflation reduction act'. Despite two quarters of recession and an increase in interest rates to 2.5%, prospects look relatively safe for H2, 2022 and 2023. Employment remains at record lows of 3.5%. Inflation is expected to come down from double figures in 2023 to around 5%. We should expect a rebound in USA equities, especially NASDAQ and the small company sector.
- The UK has enjoyed a faster growth in GDP than both France or Germany since 2019 (6.8% compared to France at 6.2 and Germany at 5.5). It has retained its position as a global super-hub in finance and services such as Law and Engineering. Instagram is locating its global HQ to London. Some 50% of Unicorns across Europe are based in this country. But the outlook is not so promising as inflation hits double digits, and the bank rate moves up to 1.75% in August (likely to reach 2.5% in 2023). Sterling could reach parity with the dollar as imports surge and the deficit widens from 2 to 7%. Lack of investment in nuclear power stations and green energy over decades will exacerbate price rises. Productivity and growth have been stagnant for two decades. The saving grace is that 75% of FTSE 100 earnings are offshore. Despite such a negative outlook, foreign investment continues to flow into the UK.
- Europe was slow to recover from Covid as Brussels bungled its inoculation programme. Dependency on Russian oil and gas could be a growing burden on the French and German economies this winter, the latter suffering also from the move to electric vehicles which has undermined its industrial power base. Germany suffered its first trading deficit for many decades in 2021. Italy has become the basket case of Europe as debt increases to 160% of GDP and the spread between Italian and German borrowing approaches 2.5%. Change of government in Italy will also contribute to further instability post Draghi's steps down. The EU is likely to fair badly this winter and could face deeper recession in 2023.
- Asia remains a divided region with some bright spots such as India and Vietnam overshadowed by Chinese sabre rattling. As the world's largest autocracy, the latter is weaponizing the South China Sea to confront its neighbours such as Australia, South Korea and Japan. It is also cosying up to other dangerous autocracies such as Iran, North Korea and Russia. Xi Jinping has declared himself ruler for life and adopts a clear strategic vision to outstrip the USA by 2030. The recent Covid troubles may delay his ambitions, but we can assume that he will adopt ruthless tactics equivalent to Putin to isolate Asia and detach the entire region from Western dependencies. Integration of Taiwan will be the first step in such a confrontation. India could be the one ray of hope, having itself militarised the Indian Ocean to curtail Chinese ambitions.

Investment themes by asset class

Value stocks are in the ascendency. 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 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 goods that can be priced up in line with inflation such as household products and drinks. Luxury goods may also be a shield against inflation: e.g., McDonalds; P&G, Unilever, Diageo, BAT.
- Pharmaceuticals that continue to benefit from global pandemics, and aging demographics. Healthcare continues to absorb a higher proportion of GDP (now at 15-20% across the globe) e.g., Astra Zeneca, Sanofi.
- Infrastructure, both vendors and operators, that include transportation, construction, and telecommunications (terrestrial and space), e.g., Ferrovial, Barrett Developments, Berkely homes, 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, Scottish Mortgage and Polar Capital, all of whom have been heavily discounted this year (Scottish Mortgage was down 50% in June).

A cautionary tale for investors

The war in Ukraine took the world by surprise this year, especially Europe who had become highly dependent on Russian energy supplies. We can expect Putin to resort to desperate measures during H2 2022 and 2023 to save face and deliver a partial victory. Nuclear weapons could be a possibility if his troops are driven back from Donbas and Crimea regions.

Of greater concern however is the situation in China. President Xi Jinping has committed to full integration of Taiwan with mainland China. The world depends on Taiwan for its supplies of silicon chips (TSMC supplies the majority of all such chips). A physical invasion or sea and air blockade of goods from Taiwan will create a global melt down in sectors such as white goods, computer devices and automotive – far more damaging than the Russian withdrawal of gas and oil from Europe. Nancy Pelosi's recent visit to Taiwan has accelerated such a possibility, as has the strong partnership between Putin and Xi Jinping. China is watching the war in Ukraine carefully whilst expanding its army in readiness for an attack. We could see action in 2023.

The third area is Iran. As one of the most dangerous autocracies in the world, it is close to acquiring full nuclear weapons capability. Its vowed intention is to wipe Israel off the map. Having developed proxy armies on the northern and western borders of Israel (Hezbollah alone has 150,000 missiles aimed at Israel – all supplied by Iran) it could deter Israel in responding. But Israel and some other Middle East countries will not accept a nuclear rogue state in their midst. We can expect an escalation of attacks by Israel and Iran's proxies with the possibly of a full-scale war in the coming months – especially as nuclear disarmament talks in Vienna fail to produce an outcome.

Taken together such possibilities offer a strong note of caution to any equity-based investment strategy.

Arranging an investment portfolio for 2023

Here is a possible reallocation of assets for 2023. See Figure 2 below

Asset Class	2022 allocation	2023 allocation	Rational
Liquid assets (cash, strategic Bonds)	15%	20%	Stay ready for any market corrections
Old Economy (FTSE)	25%	20%	Exploit value opportunities
Tech stocks	25%	20%	Recovery prospects
Asia/China/India	20%	15%	Position for growth
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 (20%) due to market uncertainties – but remember that inflation will bite heavily into this asset class. Cash can be deployed by late 2022 as the picture for 2023 becomes a little clearer.
- Load the portfolio with value stocks (around 50%) by adopting Global, FTSE and S&P funds. 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 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 20%), 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 has been a tough year for investors with contraction in virtually all asset classes. A neutral outcome for the year would be a highly satisfactory result. Given double digit inflation, staying in cash is hardly an option for 2023 and beyond.

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.

And being an active investor now could bring longer term benefits. As Warren Buffett has said repeatedly,

> *“be fearful when others are greedy, and greedy when others are fearful”*
>
> *Roger Camrass – August 2022*

[1] Investment Report 2021 – Lockdown 3.0: East meets West available on www.rogercamrass.com/publications

Roger Camrass
Lead researcher

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.

See **rogercamrass.com**

CIONET
What's next.