THE OXFORD METRICA REVIEW

# ROADS TO RECOVERY ARE QUICKENING

OXFORD
METRICA

N. 02 / 2022

There is certainly enough trouble around the world today, ranging from wars - wars both real and trade - to polarized politics, a new era of protest and global jingoism. As global investors we are faced with the prospects of a global recession, high inflation and falling asset prices. A bleak prospect indeed - and one supported by the continual barrage of negativity peddled by the media and here in the UK the PM and Chancellor - our very own Doctors Doom & Gloom - are adding to the fear. But theirs is a narrative we do not accept. On the contrary, we believe that global markets (apart from the UK) will recover strongly in 2023.

**Let's begin with a brief if depressing *tour d'horizon***

POLITICAL RISK IS NOW INVESTORS' TOP CONCERN

Clearly, the war in Ukraine is a human tragedy which has not only disrupted food and energy supplies it has shaken confidence in what we thought was a new world order, political risk has not been a major factor in equity pricing for the last few decades; it is now. A recent survey by UBS shows that 55% of investors rank geopolitical risk a top concern (*UBS Investor Sentiment survey, November 2022*). After an initial set-back in early 2020, the market recovered from Covid and was above the pre-Covid high in a year. The start of the Ukraine war in February caused another drop from the new high and to date more than half of this loss has been recovered (see Figure 1). US-China tensions together with the Ukraine war have caused much fragmentation and de-globalization, which not only slows world growth with trade tariffs but is highly inflationary for monetary reasons. The Chinese long lock-down has weighed equally heavily on world growth. Guangzhou (formerly Canton) witnessed six million locked down at the weekend.

The combination of these factors has conspired to fuel inflation which has prompted central banks to hike interest rates, and governments to re-program fiscal policies largely in response to lockdown-induced debt. The emergence of inflation is causing central banks some consternation not least because the incumbent governors have little experience of high inflation on this scale which we have not seen since the seventies.

**What could possibly go wrong?**

The tightrope walk for the governors of central banks requires them to raise interest rates to dampen inflation but not too fast or too high as growth will be suppressed. The near-term aim is to contain inflation and then to bring interest rates back down to promote growth, the so called "soft-landing". High inflation has thus led to increased interest rates. As a result, we are starting to see signs of industrial action, especially in the UK, which will further fuel the downward spiral. These factors combine to introduce considerable uncertainty which is reflected in a substantial increase in currency and equity price volatility. Overall, the economic situation is finely balanced.

**Roads to recovery are quickening**

THE DOW IS EXPECTED TO REACH 37,500 BY DECEMBER 2023 WITH A 30% CHANCE OF BEING LOWER THAN THE CURRENT LEVEL OF 33,700

It is Oxford Metrica's view that 2023 will see some recovery in the global economy which will be anticipated in the equity markets with the Dow hitting 37,500 by December 2023 representing a slightly more than 10% increase. Based on these assumptions we expect the Dow to be above current levels of 33,700 by the end of December 2023 with a 70% probability and an expected value of 37,500. The downside is therefore 30%.

You may well ask why we are so optimistic. Returning to the time after the onset of COVID in early 2021 we identified five key vectors of change for the global economy, as follows: (*See Oxford Metrica 27 January 2021*)

1. Geopolitical factors
2. Inflation
3. Regulatory forces
4. Social factors
5. Technological change

These remain in our opinion the major drivers of markets and will continue to have a significant effect. On balance of probability, we are assuming the following positive developments in three of the five change vectors:

*Geopolitical factors*

Firstly, we foresee a de-escalation of the Ukraine war in Q1 after the winter. The G20 leaders in Bali, while condemning Russia, seemed to indicate their realization that their real economic problems are unlikely to be

resolved without peace returning to Ukraine. Such an easement would markedly lift markets.

Secondly, an opening up of China in March/April. This would provide a further boost to the markets. Less certain is the easing of tensions between the US and China. Our working assumption is that these will neither abate nor escalate. There has been a slight rapprochement between the PCAOB & the CSRC regarding auditing listed Chinese companies.

*Inflation*

We are assuming that inflation is peaking and that rate hikes will be discontinued in the first quarter of 2023 and at the latest in the second quarter. We expect the Fed to then be able to start signalling a reduction in rates. The "soft landing". This easing of interest rates will boost growth and earnings in the fourth quarter. The value effects of these events should be anticipated by markets in Q3.

*Government intervention*

We are also assuming that although there will be inevitable adjustments to bring down debt, with lower inflation expectations and lower interest rates, these should not bother equities too much.

However, three serious risks remain.

These are that:

THREE SERIOUS RISKS REMAIN

*Geopolitical factors go south*

The Russia/Ukraine conflict drags on or escalates with the attendant energy, food and security disruption. In the apocryphal quote attributed to Winston Churchill; *Nations always do the right thing but only after exploring every other possibility.* We fear we may be in an extended period of exploration, in which case there will be a costly drag on the world economy. China may also defer opening until 2024 or beyond - another factor to nurture a global recession with the major source of growth of the last two decades effectively being put on hold.

*Inflation is not contained*

If the medicine administered by central banks does not have the desired effect and inflation continues to rise into the second half of the year, the markets will react negatively since the inevitable continuation of interest rate hikes could trigger stagflation. However, we do not rate this so called hard-landing outcome as very likely.

*Governments take mis-steps*

There are many ways for governments to get things wrong and a rather more limited number of ways for them to get things right. Clearly most governments face a great challenge of fiscal policy in balancing the tax burden for growth and reducing government expenditure to reduce debt. We fear that some mis-steps may have already been taken here in the UK - which is why we qualified our opening argument with the words 'apart from the UK'. Without being too harsh, it seems obvious that increasing corporate tax rates to 25% is going to slow growth and tax revenues significantly.

**However roads to recovery are generally quickening**

In support of our more optimistic views on recovery it Is instructive to reflect on to the performance of stock markets over the last 100 years as analyzed in Figure 1. The chart shows the performance of the Dow Jones Index from 1 November 1922 to 1 November 2022. We have transformed the data in two ways in order to interpret them more meaningfully. Firstly converting the series into constant 2022 dollar-terms to provide a constant numeraire and, secondly scaling the data to a $logarithmic_{10}$ scale to allow comparability over time. In nominal terms the value of the index has gone from 95 to 33,700.

Two features are especially noteworthy:

Firstly, Markets have spent 76 years of the last 100 years in the red! Periods marked in red on the chart represent those intervals below an earlier high-water mark. Namely periods when they were either digging a hole or trying to climb out. The other 24 years conversely are those periods progressing above the earlier high-water mark. These are marked in white on the chart. The compound annual growth rate (CAGR) over the 100 years to the beginning of November is a mere 3% in real terms (6% in nominal terms).

Secondly, notice also how much shorter it takes in general to recover from high-water mark falls. The 1929 crash took thirty years to return to pre-crash levels, as did the 1966 bear market. The dot.com recovery was interrupted by the 2008 crash, but recovery in both took only 14 years. In stark contrast the recovery from COVID in 2020 and the recovery from the Ukraine war in 2022 took only a year in each case, although markets have not fully reached pre-war levels yet.

So, there is more volatility? Yes - but recovery times are shrinking. Placing our analysis into this longer context it is clear that markets are remarkably resilient and suggesting that an approximately 10% recovery does not now look so daunting.

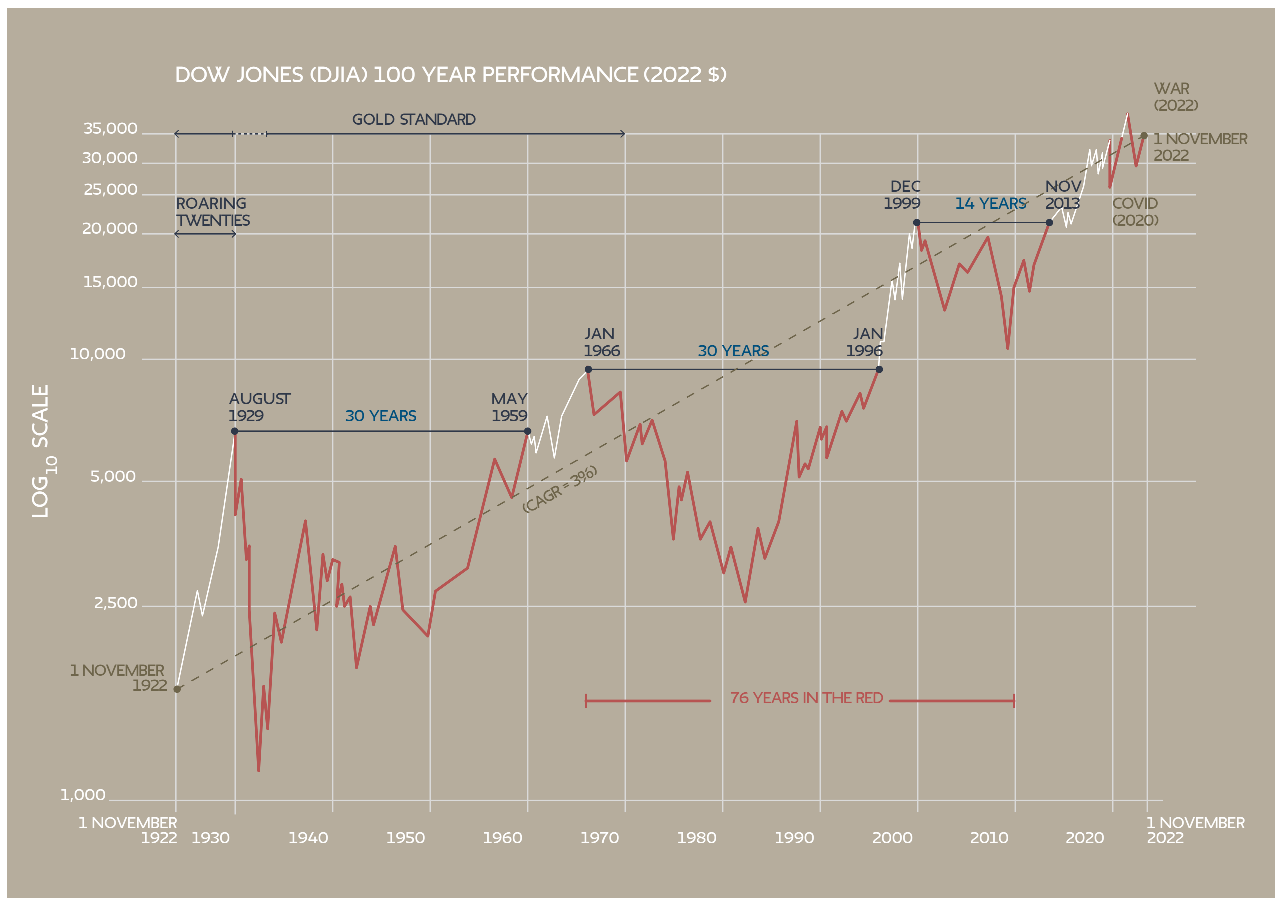
Moreover, as the chart also shows, equities in aggregate over the past one hundred years have simply not provided adequate returns. Diversification has delivered little more than a smoothing out of short-term variance in returns and adds little value to long-term investors. In short, as a long-term investor requiring a (5% + inflation) return to preserve capital in real terms one simply cannot afford passive investing. To capitalize on the developments we have outlined in this review there is in our view no alternative to active, agile and forward-looking long-term investment strategies. Setting clear investment objectives is critical.

As Yogi Bearra said, *If you don't know where you are going you are likely to end up somewhere else.*

*This edition of the Oxford Metrica Review is based on the Keynote address delivered by Oxford Metrica Chairman, Dr Rory Knight, at the OTC Markets Group Issuer Conference held at the East India Club in London on Thursday 1st December 2022. All opinions expressed are those of the Chairman alone.*

FIGURE 1. Market perfromance over the last 100 years

SOURCE: Oxford Metrica.

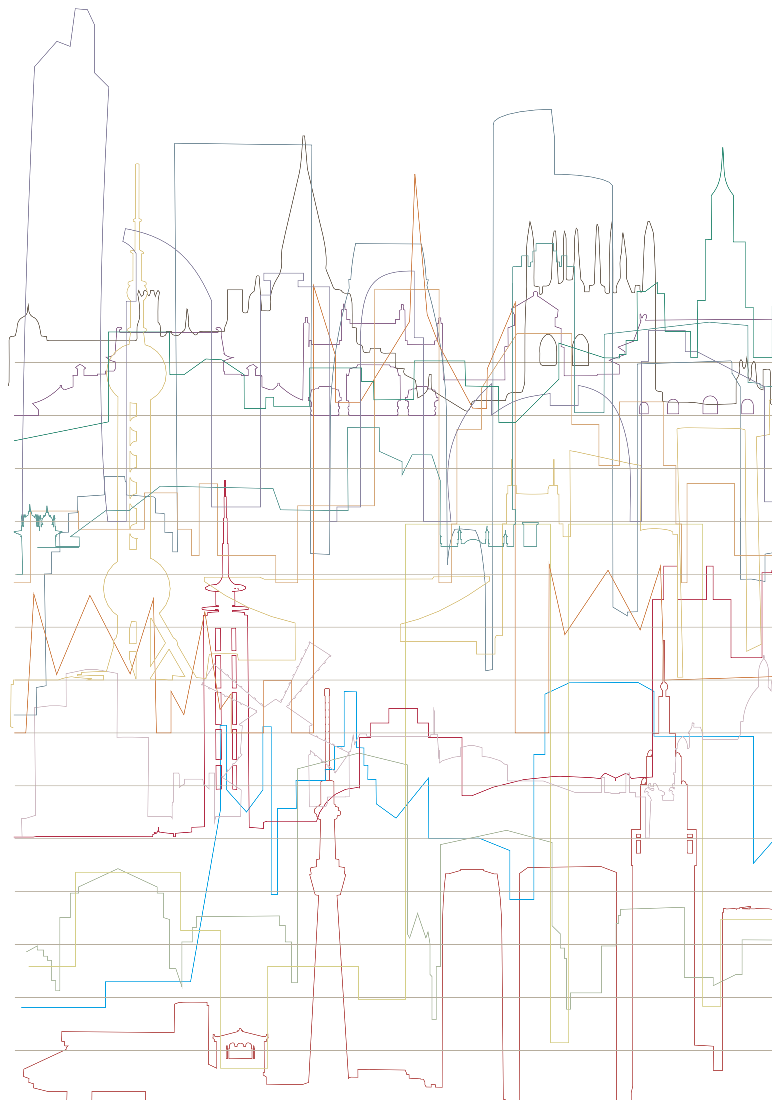


OXFORD
METRICA

Oxford Metrica is a strategic advisory firm, offering informed counsel to boards. Our advisory services are anchored on evidence-based research in risk and financial performance. Our work includes statistical analysis and index construction for banks and insurers, risk and performance analytics for asset managers, due diligence support in mergers and highly customized services for corporate boards.

**Dr Rory Knight**, is Chairman of Oxford Metrica and the investment committee at the John Templeton Foundation. He was formerly Dean of Templeton, Oxford University's business college. Prior to that Dr Knight was the vize-direktor at the Schweizerische Nationalbank (SNB) the Swiss central bank.

oxfordmetrica.com



Copyright © 2022 Oxford Metrica