by Chief Economist & Strategist Finn Øystein Bergh

FINANCIAL MARKETS AND THE ECONOMY IN 2022

Redefining risk

The past year turned out to be unusually eventful, with outright war, sharply rising interest rates and towering warnings of an imminent recession. It also turned a lot of accepted wisdom on its head.

Financial analysis is more than a myopic exercise in indicators and percentages. Lest anyone should think otherwise: The defining event of 2022, by far, was the Russian invasion of Ukraine. The financial world lost no time in condemning it as a horrifying act of aggression but, in retrospect, took far longer to realize the financial consequences. One week after the invasion, the S&P 500 was up almost 4%. At the end of the year, it was an altogether different story.

In times of crisis, capital tends to flow towards the US market, generally considered a safe haven. Not so in 2022. With a loss of 18.1%, the S&P 500 stood out in negative terms. The STOXX Europe 600 was down 10.1% and the MSCI Nordic Countries lost 7.9%, while the FTSE 100 returned 0,9% – in the black. The Norway OSE benchmark lost a mere 1.0%.

That was but one of the surprises in 2022.

ENERGY PRICES SHOOTING UP ...

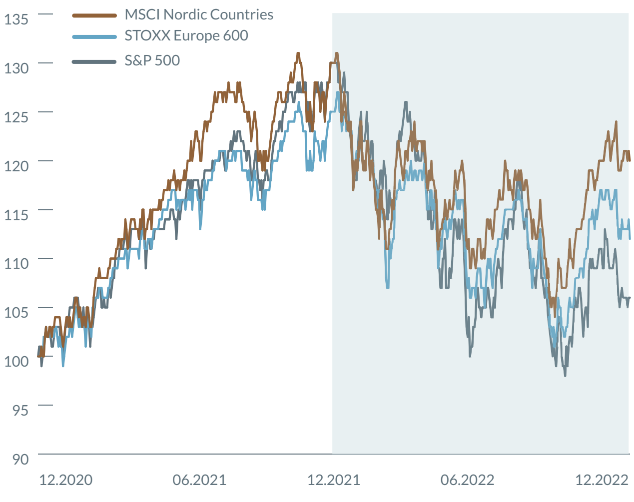
At the start of the year, all eyes were on inflation figures. The US annual headline inflation had reached 7.0 per cent and there was widespread speculation as to the actions of the US Federal Reserve. Tapering of the quantitative easing measures had begun, but the Fed funds rate still had a target range of 0-0.25%. It was to remain at that level until the middle of March.

In the meantime, on 24 February, Russia invaded neighbouring Ukraine. Besides the horror and the flagrant breach of international law sending geopolitical shockwaves throughout the world, the invasion impacted financial markets in several ways.

It soon became apparent that Russia would cut its gas supplies to Europe, or imply threats to do so, as a means of forcing major European countries – Germany in particular – to curtail their support to Ukraine. Lower volumes and unscheduled maintenance cuts did not keep Germany from mothballing the planned Nordstream 2 pipeline, whereupon the existing Nordstream 1 pipeline was suddenly destroyed through an explosion in the Baltic Sea.

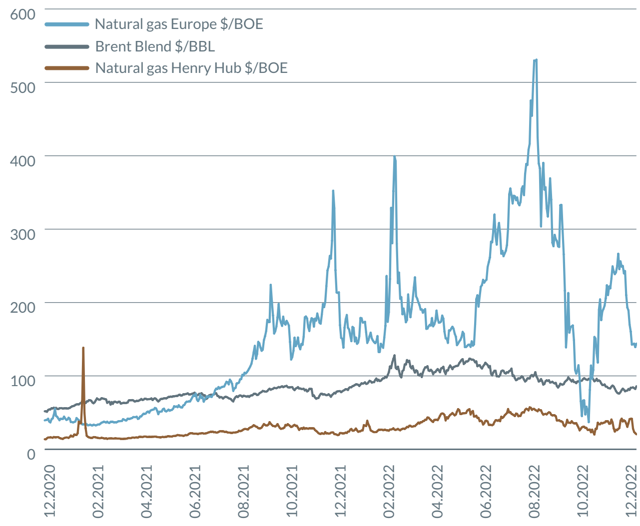
This pushed European prices on natural gas sky-high, reaching $400 per barrel of oil equivalent shortly after the invasion and then $530 per boe in August. As it became clear that Germany had acquired enough natural gas to get through the winter, 2022 ended with natural gas for European delivery at approximately $140 per boe.

The end of a beautiful relationship?



Total return indices, 31.12.20 = 100. Source: FactSet

Natural gas prices



Source: FactSet

A closer look at natural gas prices reveals that the gas threat was probably prepared months in advance, as reduced volumes had made prices rise from the summer of 2021. Crude oil also became more expensive during this time, but after climbing to almost $130 per barrel in March, it slowly fell to $86 before the year was through.

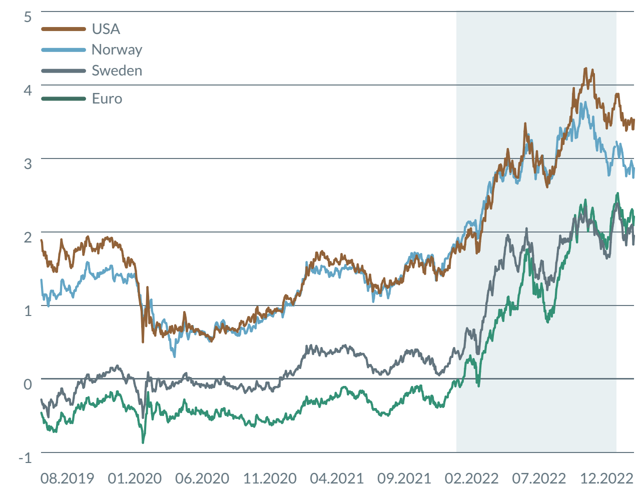
… FUELLING INFLATION

Higher gas prices also led to higher electricity prices in Europe, fuelling inflation, while the previous increase in the oil price filtered through to US inflation. In addition, because of the war, shipments of grain and other commodities from Ukraine were cut back or cut completely.

Furthermore, bottlenecks arising from the pandemic had still not been resolved. For much of 2022, China enforced very strict Covid restrictions, impeding shipments from Chinese ports and leading to scarcity of vital components in many products. Commodity prices rose further, peaking in the second half of the year.

As the year came to an end, the Fed funds rate had been hiked by a total of 4.25 percentage points, with hints of more to come. The European Central Bank (ECB), which maintained a negative deposit rate all the way until the end of July, increased its key rates by 3.0 percentage points through the remaining five months.

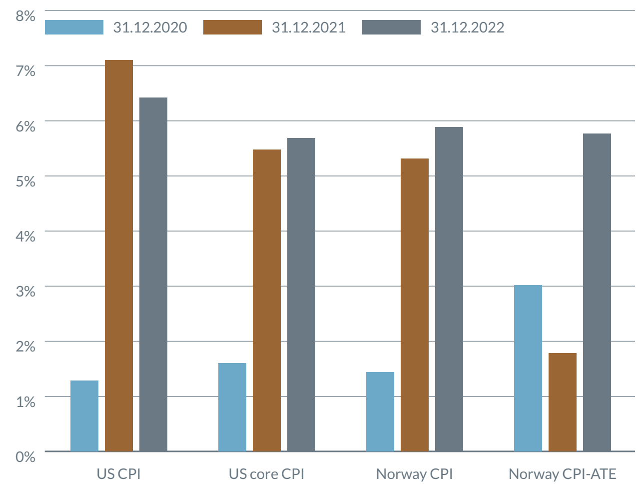
The 2022 interest rate shock



Per cent, yield to maturity, 10-year sovereign benchmark bonds. Source: FactSet

In retrospect, it may seem that all central banks were behind in countering inflation. Inflation figures were high already at the outset of 2022, while interest rates were still low or negative. Through the year, however, they have been falling somewhat – or started to fall – in most economies. The question now is to what extent present inflation will fuel demands for wage

Rising CPI figures



Year-on-year inflation, per cent. Source: FactSet

increases. A still strong real economy in both the US and Europe has increased labour market participation and cut unemployment figures. So far, few ripples of the financial markets' anxiety have been visible in the job market.

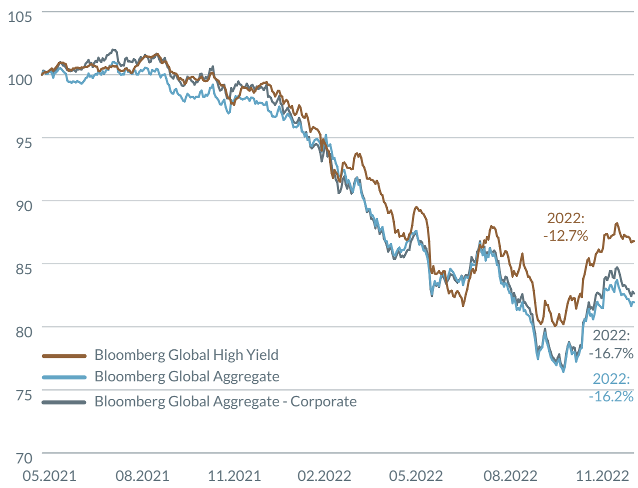
FLIGHT TO … SAFETY FROM WHAT?

Another distinguishing feature of financial anxiety is that capital flows towards presumably safer asset classes, like US Treasuries. Not so in 2022, however. The sharply higher interest rates had a devastating impact on global bond markets, dominated by long-duration bonds with fixed coupons. The S&P US Treasury Bond 10+ Year Index, meant to capture the performance of long-dated US government bonds (duration 16.3), fell by a staggering 29.4 per cent.

Risk-free loss

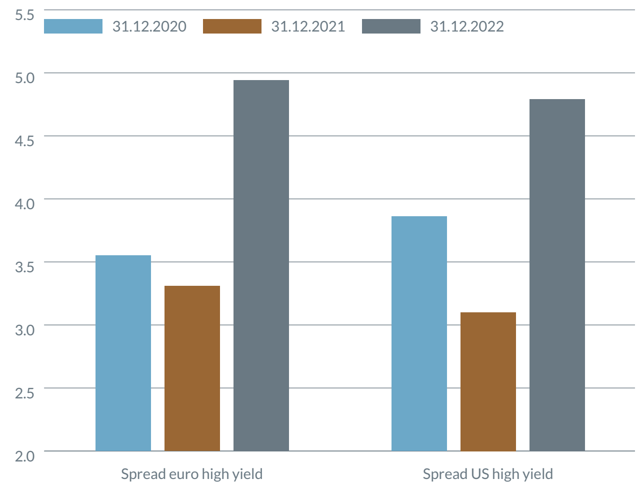
The S&P U.S. Treasury Bond 10+ Year Index. Source: S&P Dow Jones Indices

Losing 1/6 of the value in some of the safest bonds possible ...



Source: FactSet

From risk-on to risk-off



Percentage points, high-yield credit spread above Treasury spot curve.
Source: FRED, St. Louis Fed.

In the last annual survey by PwC and the Finance Society Norway, half the respondents listed the yield on 10-year government bonds as their preferred choice of risk-free return (or rather source thereof). Similarly, long US Treasuries are often used as a risk-free rate in valuation exercises. In credit terms, these are indeed as close to risk-free as can be had in capital markets. In terms of interest-rate risk, they are not.

In 2022, interest rate risk dominated credit risk, despite a notable rise in corporate credit spreads. As four decades of mostly expansionary monetary policies came to an end, long US Treasuries lost more money than most stock markets, almost matching the -32.5% of the Nasdaq Composite Index.

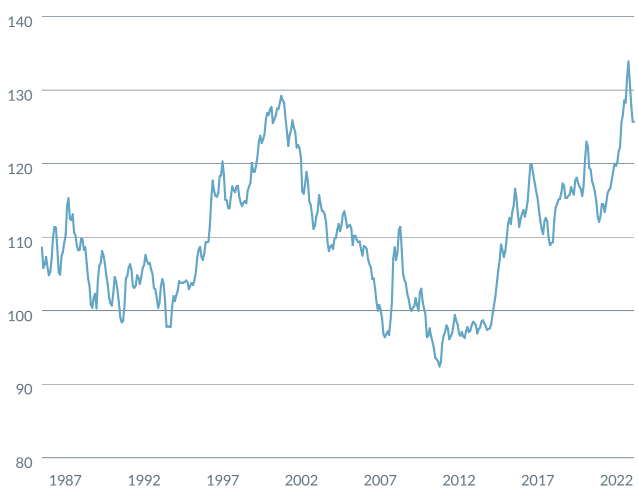
In the currency market, though, capital flows conformed to traditional behaviour. The US dollar strengthened against all other currencies, both the euro and in particular smaller currencies like the Swedish krona and the Norwegian krone. The USD/SEK rose by more than 15% in 2022. At the end of the year, the real effective USD exchange rate reached levels not seen for at least 35 years.

... (STILL) WAITING FOR RECESSION

Rising credit spreads was but one sign of a decidedly more risk-off market sentiment. In the US, the term spread – the yield on 10-year Treasuries less the yield on 2-year Treasuries – turned negative in July, with Europe following suit a few months later. This is a classic recession indicator, which few failed to mention. In Google searches, the term “recession” was more than five times as frequent after the invasion as in 2021. In financial media and blog posts alike, recession calls kept coming for both 2022 and 2023.

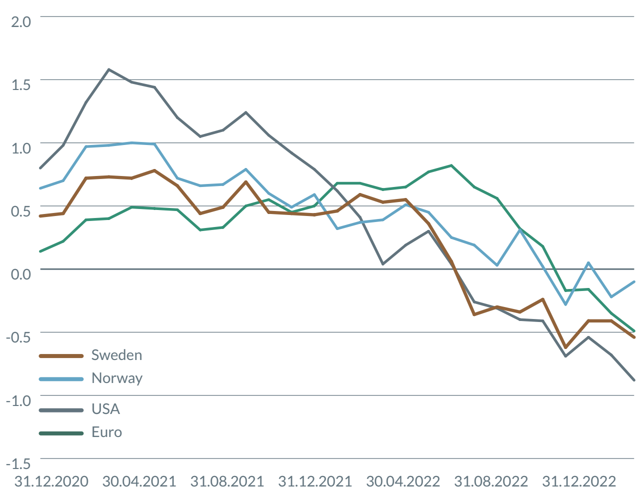
Indeed, GDP growth estimates were cut across the board, with the IMF slashing growth estimates for 2022 in each of their four updates through the year. So far, however, no recession seemed to materialise. Most advanced economies were remarkably resilient, countering rising interest rates, rising commodity prices, supply chain bottlenecks and shortages in many lines of business.

Mighty - or expensive - dollar



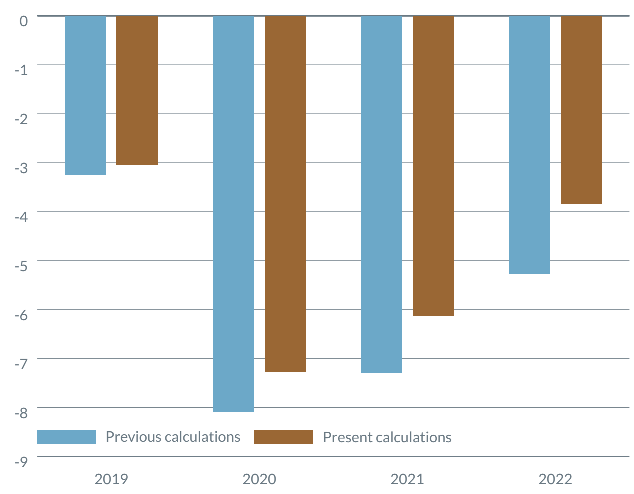
Real effective exchange rate, US dollar. Source: IMF, FactSet

Widespread bond yield inversion



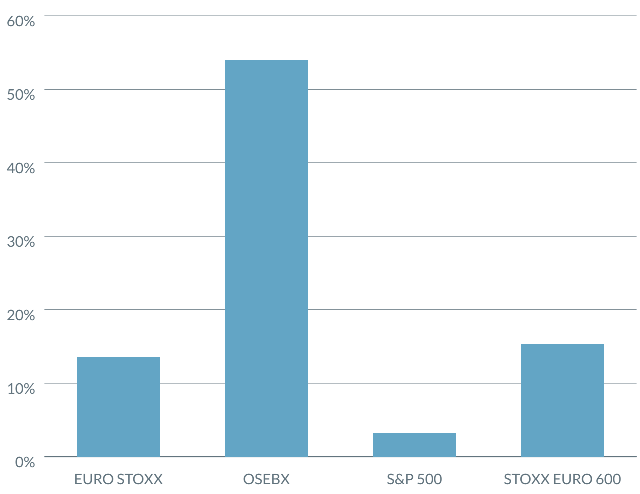
Term spread: yield on 10-year government bonds less yield on 2-year government bonds.
Source: FactSet, Pareto Asset Management

Reassessing prodigality



Advanced economies, cyclically adjusted deficit, present estimate and calculations one year ago. Source: IMF

Earnings recession? Not yet



Per cent change in next 12 months EPS estimates through 2022.
Source: FactSet

Normally, with monetary policies tightening, there will be pressure towards somewhat more accommodative fiscal policies. As it happens, fiscal policies have been extremely expansionary since the outbreak of the pandemic, although more recent calculations show that the structural deficits were not as large as previously thought. A more accommodative stance is not a given, however. In the US, a fight over the debt ceiling is likely to ensue. In Europe, high debt levels in many countries may square poorly with higher interest rate levels.

On the other hand, further monetary tightening is not a given, either. At the time of writing this, the Silicon Valley Bank collapse has just occurred, producing a major decline in market interest rates. This serves as a reminder that the major market movers in any given year are typically those that were not in the cards at the beginning of the year. Surprises tend to make forecasts obsolete.

EARNINGS RECESSION?

A particular source of concern has been the concept of earnings recession, generally defined as a large majority of companies experiencing lower earnings than a year ago for at least two consecutive quarters. In 2022, earnings were far from falling into a recession. Instead, estimates for the next 12 months kept rising through the year, especially for the Norwegian OSE benchmark index. This was partly due to the strong earnings of local giant Equinor, on the back of higher gas prices as Norway and Equinor took centre stage in supplying gas to Europe.

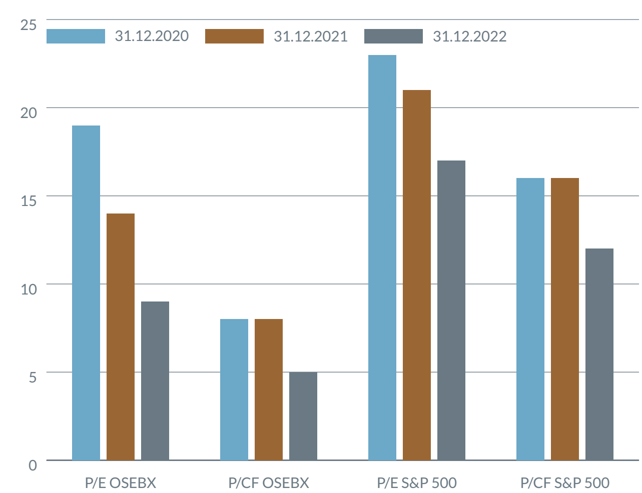
In general, despite most companies being negatively affected by higher energy costs, European estimates were strong, increasing by more than US earnings estimates. Furthermore, they weren't missing the mark, at least no more than usual – some concurrent revisions are always to be expected.

The resilient earnings may come as a surprise. After all, real economic growth did fall in 2022 and there is a strong consensus that it will be lower in 2023, given the moderate success so far in curtailing inflation. And earnings are likely to fall, perhaps sharply, should there be a recession. The aggregate opinion of security analysts, then, a few weeks into 2023, is that we will not have a recession in 2023 either. Conclusions drawn from the bottom-up perspective may differ considerably from those based on a top-down view.

MUCH LOWER STOCK MARKET PRICING

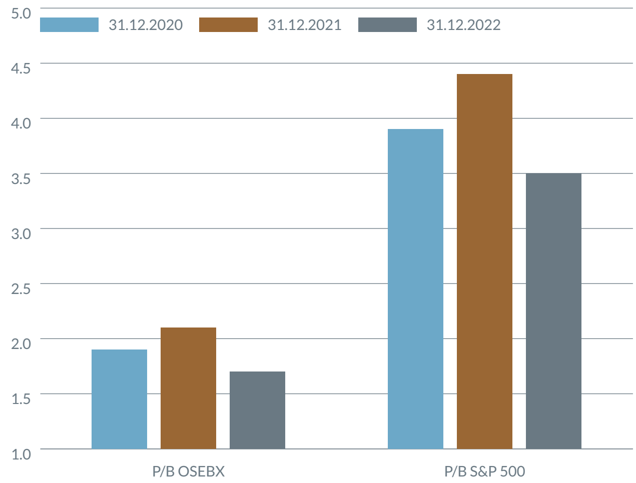
The combination of lower stock prices and rising earnings meant that pricing in the stock market was notably reduced during 2022. For the S&P 500, forward P/E was reduced by more than 1/5, following a more moderate fall in the preceding year. Similarly, in terms of book values, which fluctuate less than earnings, stocks became cheaper in most markets and segments. In 2022, reversing a trend from previous years, stock investors got more book for the buck.

Firesale or mirage?



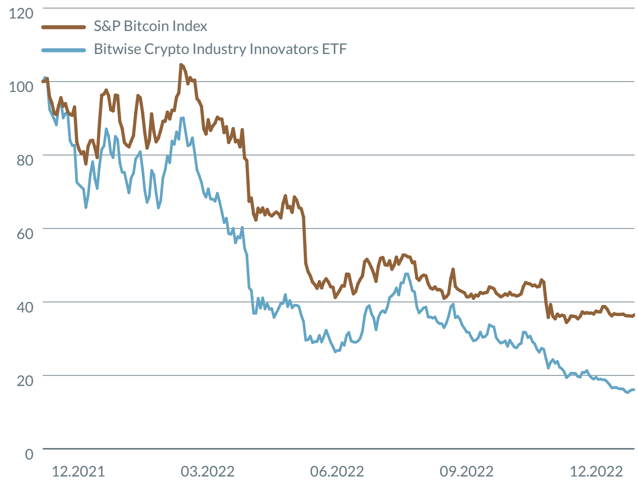
Source: FactSet

More book for the buck



Source: FactSet

When the only source of return is the next investor



Crypto currencies plummeted in 2022 - if they survived.
Source: S&P Dow Jones Indices, FactSet

The pricing changes were strikingly unevenly distributed, as the higher priced stocks experienced large declines while more moderately priced stocks stood firm. The MSCI World Index, which fell by 15.6% in 2022, holds both value stocks and growth stocks, as defined by different multiples. The MSCI World Value Index comprises roughly half of the index, the value part, with the MSCI World Growth Index holding the other half. In 2022, the former hardly budged, falling by a very modest 3%, whereas the latter plummeted by 27%. The record-high difference reflects the vastly different interest rate sensitivities in a year of unusually large interest rate movements.

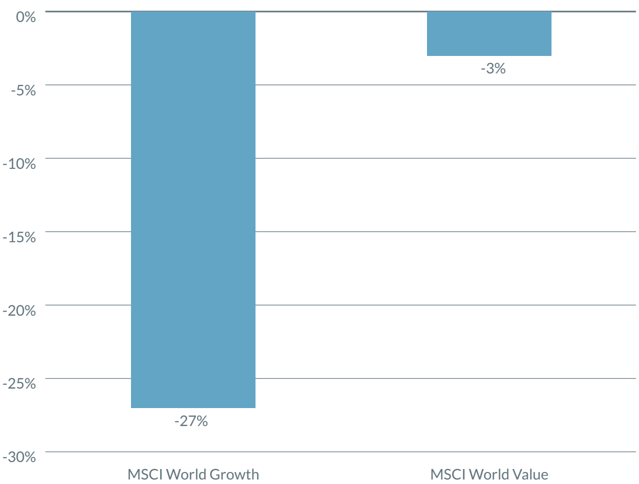
Some investments were even harder hit. Crypto currencies, which I personally fail to see as a genuine investment, lost 60% or more of their value in 2022. And then, of course, came the much-publicised bankruptcy in the crypto-currency exchange FTX in November 2022. Apparently, this is a matter of more than naiveté or stupidity; a criminal investigation was initiated.

Either way, an investment with no earnings, no yield, no production – in short, no fundamental return in any form – will logically be more sensitive to interest rate changes. One might surmise that this does not apply to gold, often hailed as a safe haven in times of turmoil. In 2022, however, gold was basically flat, ending just below last year's final quotation.

GROWTH SLOWING DOWN

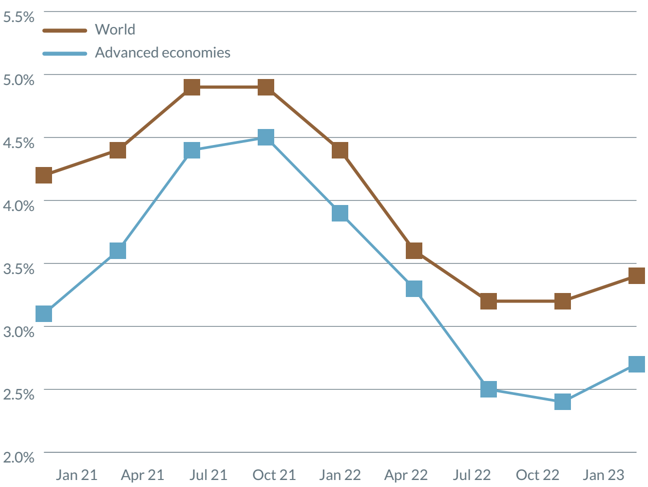
In its January 2023 update, the International Monetary Fund (IMF) revised its 2023 global growth estimate upwards, to 2.9% from 2.7%, after a number of downward revisions during the past year. This both reflects a somewhat lighter mood and serves as a reminder that economic growth will, after all, be modest or muted in 2023. The impact on financial markets will largely depend on the path of concurrent and expected interest rates.

The grizzly and the teddy bear market



Source: FactSet

Changing sentiment tides



Per cent, IMF 2022 growth estimates published at different points in time.

Just remember that market movements induced by interest changes are inherently short-term in nature. Here's an interesting if not overly scientific comparison:

On 15 December 2022, the FMOC increased the lower bound target Fed funds rate to 4.25%. It hit the same level on 17 May 1994. Since then, up to the end of 2022, the S&P 500 has delivered a compound return of 1,378%, corresponding to an annual average return of 9.9%.

In Norway, the key interest rate ended the year at 2.75%. It was set to 2.5% on 18 September 2003. In the ensuing years, the Norwegian benchmark index has notched up a total return of 681%, corresponding to an annual average return of 11.2%.

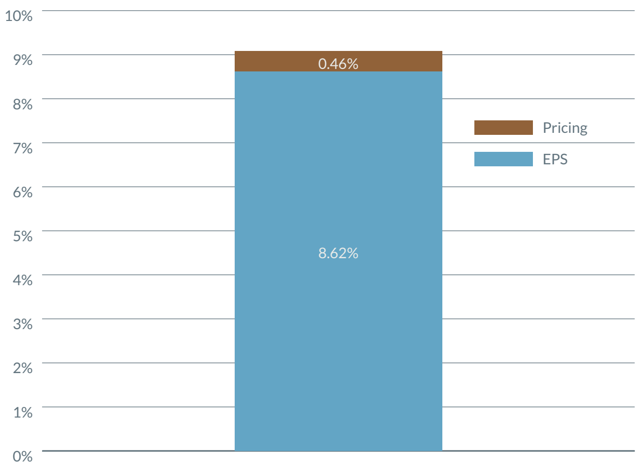
Yes, I know – the direction of the interest rate change makes a difference in the short term. Longer-term, however, another factor is far more important: earnings.

WHAT REALLY MATTERS

Let's decompose S&P 500 returns going back to 1871, which is as long-term as it gets in terms of earnings series. Over these more than 150 years, the average annual compound return computes to 9.1 per cent. In real terms, adjusted for US inflation, it is a still impressive 6.9 per cent, despite the downturn in 2022.

Of course, stocks are priced a lot higher than in 1871. According to economist Robert Shiller, whose data I have downloaded, average P/E has doubled, from 11 to 22 (these are historical multiples, not forward-looking). If this had happened in the space of one year, it would – roughly speaking – have doubled that year's return.

It's all about earnings



Percentage points, contribution to S&P 500 total return 1871-2022.
Source: Robert Shiller, Pareto Asset Management

Over more than 150 years, however, it contributes only 0.46 percentage points to the compound return. Fully 95 per cent of the compound return can be attributed to rising earnings.

These figures convey a clear advice not to get lost in the vast array of indicators and figures available at the touch of a key. If you're looking for arguments to support your market view, you need not spend a lot of effort searching – whatever your view. There's always a host of seemingly relevant numbers available. As time goes by, however, their importance dwindles.

Remember: you make money because your investments do.

2022 in a nutshell	
OSEBX	-1.0%
S&P 500 return	-18.1%
MSCI World net (USD)	-18.1%
3-month NIBOR	from 0.95% to 3.26%
10-year Norwegian Treasury	from 1.70% to 3.17%
10-year Swedish Treasury	from 0.21% to 2.39%
10-year US Treasury	from 1.51% to 3.88%
Brent Blend	from USD 77.78 to USD 85.91
USD/NOK	from 8.82 to 9.85
EUR/NOK	from 10.03 to 10.51
USD/SEK	from 9.05 to 10.42
GDP growth, global	3.4%
GDP growth, Norway	3.3%
GDP growth, Sweden	2.6%
GDP growth, Mainland Norway	3.8%

Sources: Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, SSB, SCB, Riksbanken, Pareto.