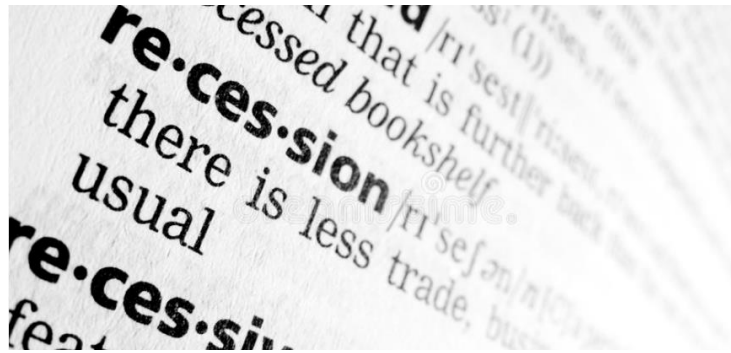


The Absolute Return Letter



January 2023

The R Year

“We are in the fight of our lives, and we are losing.”

Antonio Guterres

Farewell to a very challenging year

2022 wasn't the easiest of years to handle for investors. Exceptionally high food price inflation, only surpassed by even higher energy price inflation, led to a cost-of-living crisis in many countries, and it is far from over yet. On top of that, a special military operation in Ukraine (Putin has advised me not to call it a war) brought what we Westerners typically call war back to mainland Europe after years of relative calm and prosperity.

As if that wasn't enough, COVID-19 just wouldn't go away. Neither would many of the supply chain problems we have suffered from. And, to add insult to injury, property prices started to weaken worldwide, and rising property prices have been a major part of the foundation underneath the bull market we have enjoyed more recently.

Therefore, it should come as no surprise that it has been a very poor year for equities in most countries. In no particular order, the DAX index in Frankfurt delivered -12.35%, the CAC 40 index in Paris -6.60%, the IBEX 35 index in Madrid -2.02%, the FTSE 100 index in London +4.57% (!), the TSX Composite index in Toronto -5.75% and the Nikkei 225 index in Tokyo -7.38%.

However, of the major equity markets around the world, by far the worst performing ones could be found in Shanghai, Seoul and New York. All those markets were down about 20% or more with the NASDAQ index being the ultimate 'winner', as it delivered a 2022 return to investors of -32.51%. The stock exchanges in Shanghai, Seoul and New York are all heavily exposed to tech. When you take into account the very poor performance of tech worldwide in 2022, one shouldn't be that surprised to learn that these equity markets did particularly poorly last year.

One final observation before I move on: London delivered, as the only major stock exchange, a positive return in 2022. In effect, UK equities turned into a classic risk-off investment. On days global equities did well, they underperformed quite dramatically but, on the many negative days last year, they were the standout performer. Why is that? Effectively, it boils down to Brexit. Because of all the carnage that Brexit has brought, UK equities are out of favour worldwide, and that has resulted in exceptionally low P/E ratios and very attractive dividend yields – two valuation measures which have provided

plenty of support on weak days. However, are the numbers attractive enough to warrant an investment? That depends on your views on Brexit, I suppose.

Saxo Bank's Ten Outrageous Predictions

Let's move on to one of the highlights of the year for me – Saxo Bank's Ten Outrageous Predictions. When that list is published, Christmas begins for me. I get plenty of Christmas presents every year (one of the many joys of having a large family), but this one is one of my firm favourites. In the days leading up to Christmas, I have a new toy to play with. Let me share with you how Saxo Bank introduced its Ten Outrageous Predictions this year:

"Gone are the days where low interest rates could foster dreams of a harmonious world built on renewable energy, equality and independent central banks. In 2023, world economies will shift into War Economy mode, where sovereign economic gains and self-reliance trump globalisation."

In other words, Saxo Bank fear that 2023 might bring a regime change, where sovereign selfishness trumps globalisation. While the ten predictions do not constitute Saxo Bank's official forecasts, according to the bank, they represent a warning against the potential misallocation of risk among investors, who might assign a very low chance of these events materialising. It's an exercise in considering the full extent of what is possible, even if not necessarily probable. As Saxo Bank state, the outcomes that prove the most disruptive are those that are a surprise to consensus. Now the Ten Outrageous Predictions for 2023:

1. Billionaire coalition creates trillion-dollar Manhattan Project for energy.
2. French President Macron resigns.
3. Gold rockets to USD 3,000 as central banks fail on inflation mandate.
4. EU Army forces EU down path to full union.
5. A country agrees to ban all meat production by 2030.
6. UK holds UnBrexit referendum.
7. Widespread price controls are introduced to cap official inflation.
8. OPEC+ & Chindia walk out of the IMF, agree to trade with new reserve asset
9. JPY fixed to the USD at 200 as Japan overhauls financial system.
10. Tax haven ban kills private equity.

The analysts at Saxo Bank provide further insight on all ten 'predictions' on its website. I suggest you click [here](#) if you want to dig a bit deeper on the topic.

2½ out of 3!

Every year, I run my own set of not-so-outrageous predictions and, last year, I projected that:

- i. inflation would turn out to be a far bigger problem than the transitory issue Jerome Powell claimed it was and that, as a consequence, interest rates would go much higher than most believed at the time;
- ii. the Federal Reserve Bank would turn off the liquidity tap – a tap which has been wide open since the Global Financial Crisis; and that
- iii. China would be plagued by unrest, and that the unrest would ultimately turn into another Lehman moment.

Only the Lehman moment hasn't materialised (yet), even if China has been plagued by plenty of unrest in 2022. I am pretty happy with a score of 2 ½ out of 3. Now to the difficult part – what is 2023 likely to bring?

Our not so outrageous predictions for 2023

1. 2023 will be a year characterised by poor economic performance all over the OECD (and possibly even wider). Particularly in the US, earnings expectations remain too optimistic and, as companies struggle to meet those expectations, equities will fall further.
2. The war economy, mentioned by Saxo Bank, is not a risk but a reality. New alliances will be established, and new trading patterns will emerge. As a result, Russia will find it easier to sell its oil and gas than the western allies would like. Consequently, Russia will find the means to finance its war machine, and the war in Ukraine will drag out, resulting in higher energy prices for longer.
3. Poor compliance with the climate rules introduced in Paris in 2015 will worsen the ongoing climate crisis.

#1 – Poor economic performance in the cards

The economic outlook globally is pretty grim. The UK is almost certainly already in recession. The EU is most likely about to enter one, and the data coming out of the US tells me that a recession over there in the second half of 2023 is increasingly likely. However, unlike most of Europe, the US downturn is not imminent. In an OECD context, Japan looks by far the healthiest economy as we enter a New Year, and I would expect Japanese GDP growth in 2023 to exceed that of most European countries and possibly even that of the US.

China is a basket case and almost impossible to predict. Until a few weeks ago, I was quite bullish on Chinese GDP growth this year. The political leadership was finally softening its stance on COVID-19, and a strong recovery this year was on the cards. However, as we approached Christmas, the COVID numbers began to worsen, and the big cities started to close down again. Consequently, I won't even attempt to sound smart on China. I have no idea what to expect.

Developments in the US will most likely dictate the sentiment in financial markets all over the world. Investors have already largely discounted the oncoming recession in Europe, whereas the same is not the case in the US. As of a few days ago, the Stoxx Europe 600 traded at a 30% discount to the S&P 500 despite European companies delivering better results than US companies (Exhibit 1).



Exhibit 1: Stoxx Europe 600 vs. S&P 500

Source: *Bloomberg*

Therefore, I would expect a European recession to have a less dramatic impact on European equity prices than a US recession would have on US equity prices. Having said that, given the preeminent status of US equity markets worldwide, a US recession will most likely have a negative impact on equity markets worldwide.

#2 – The war economy takes over

Almost a year into the armed conflict in Ukraine, the wider impact of the war is still unpredictable. New trade alliances are being formed, and new trade patterns are emerging, but to predict precisely how this will all unfold is impossible. One of the more

likely outcomes is that many EM countries will seek to lessen their dependence on Europe and North America.

It may be difficult for many westerners to understand (I am struggling myself), but there is a view in parts of the world (e.g. parts of Africa, the Middle East and the Indian subcontinent) that Putin is only trying to take back what he is entitled to. That, combined with the fact that Russia is offering oil and gas to many EM countries at a hefty discount, will most likely drive them into the arms of Russia and China.

In 2023, the biggest risk to our part of the world, economically speaking, is that the war in Ukraine drags out, and that Putin opts to increasingly use oil and gas as a weapon against Ukraine's European allies, just as he tried to do in 2022 (with some success), possibly leading to even higher energy prices this year.

Europe continues to be *very* dependent on Russia for both oil, gas and coal. Exhibit 2 below is hard to read (click on [iea.org](https://www.iea.org) if you want access to the precise data), but this is how to read the chart: the vertical axis measures what percentage of total fossil fuel imports comes from Russia. Take for example Lithuania. As you can see, they get all their fossil fuels from Russia.



Exhibit 2: Reliance on Russian fossil fuels, 1990-2021

Source: [iea.org](https://www.iea.org)

As you can see, some of the biggest European countries are also quite dependent on Russian fossil fuels. Germany, for example, imports about 30% of its fossil fuels from Russia. In Italy, the corresponding number is 24% and in Poland 29%. If we don't find a solution to the war in Ukraine relatively soon, the economic downturn in Europe could be quite severe this year.

#3 – The climate crisis goes from bad to worse

I am increasingly concerned that the train may already have left the platform, that the damage to our climate has reached a point where it has become irreversible, and here is why: The greenhouse gas (GHG) problem is *not* a function of present emission levels but of cumulative emissions since the early days of the industrial revolution some 250 years

ago. Therefore, even if the use of fossil fuels were to be discontinued tomorrow morning (and we are still at least 30-40 years away from that happening), there is already enough CO₂ and other GHGs in the atmosphere to do immense damage.

The only way we may be able to guide the train back to the platform is if we could develop a technology that would not only capture the carbon in the atmosphere but also use it again. (If you subscribe to ARP+, you may recall that, about six weeks ago, we published a paper on carbon capture. If you haven't read it yet, we urge you to do so, as it is a critically important topic. You can find it [here](#).)

If such a technology could be developed, and researchers are on to the challenge, Net Zero could be turned into Net Negative. And, as you can probably sense from my choice of words, it is becoming increasingly obvious that Net Zero is no longer enough. Net Negative is fast becoming a *must*.

From an investment point-of-view, you may wonder why I have chosen to add this to our 2023 list of concerns. Isn't climate change an issue of a more general nature? Yes, it most definitely is, but there are also some specific short-term issues that warrant an inclusion on the 2023 list.

For example, the Arctic ice sheet is melting very fast now – about three times as fast as the rest of the world – and the Arctic contains a large share of the carbon stored in permafrost areas around the world — an estimated 1,500 gigatons, or twice as much as the atmosphere contains (source: climate.mit.edu). As the Arctic ice sheet melts, that CO₂ will end up in the atmosphere. Once in the atmosphere, it will further warm our planet, creating a positive feedback loop that thaws even more permafrost.

The thawing of the Arctic ice sheet has been largely ignored by most investors up to this point, probably because general wisdom is that the thawing of the Arctic ice sheet will have little effect on sea water levels (which is correct); however, the impact on GHG emission levels from a thawing Arctic ice sheet is clearly not that well understood. When the penny drops, the issue could affect financial markets quite dramatically.

Final few words

That was a snap review of our 2023 predictions. It is pretty obvious that much more could be said about each of those three predictions/risks, and I will do that over the next few months; however, given the space I am allocated per letter, this must suffice for now.

Niels C. Jensen

3 January 2023

Important Notice

This material has been prepared by Absolute Return Partners LLP (ARP). ARP is authorised and regulated by the Financial Conduct Authority in the United Kingdom. It is provided for information purposes, is intended for your use only and does not constitute an invitation or offer to subscribe for or purchase any of the products or services mentioned. The information provided is not intended to provide a sufficient basis on which to make an investment decision. Information and opinions presented in this material have been obtained or derived from sources believed by ARP to be reliable, but ARP makes no representation as to their accuracy or completeness. ARP accepts no liability for any loss arising from the use of this material. The results referred to in this document are not a guide to the future performance of ARP. The value of investments can go down as well as up and the implementation of the approach described does not guarantee positive performance. Any reference to potential asset allocation and potential returns do not represent and should not be interpreted as projections.

Absolute Return Partners

Absolute Return Partners LLP is a London based client-driven, alternative investment boutique. We provide independent asset management and investment advisory services globally to institutional investors.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe we can achieve that through our thematic investment philosophy combined with a disciplined risk management approach.

Our product development, asset allocation and portfolio construction are all driven by the seven megatrends we have identified. We frequently refer to those megatrends in the Absolute Return Letter.

We have eliminated all conflicts of interest with our transparent business model, and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Conduct Authority in the UK.

Visit www.arpinvestments.com to learn more about us.

Absolute Return Letter contributors:

Niels C. Jensen	nj@arpinvestments.com	T +44 20 8939 2900
Mark Moloney	mm@arpinvestments.com	T +44 20 8939 2900
Emily Alexander	ea@arpinvestments.com	T +44 20 8939 2900