Crossbow Partners
Experience & Discipline

# London Trip Report

London, Dec 6th - 7th 2022


***Executive Summary***

*The majority of generalist Long/Short Equity managers have a tempered to negative outlook for equity markets in 2023. Key issue weighing on their outlook is earnings in Q1 2023.*

*Consumption is expected to decline as inflation puts a squeeze on living standards and consumers can no longer tap into their savings. This would feed through to corporate earnings and lead to a decline in GDP.*

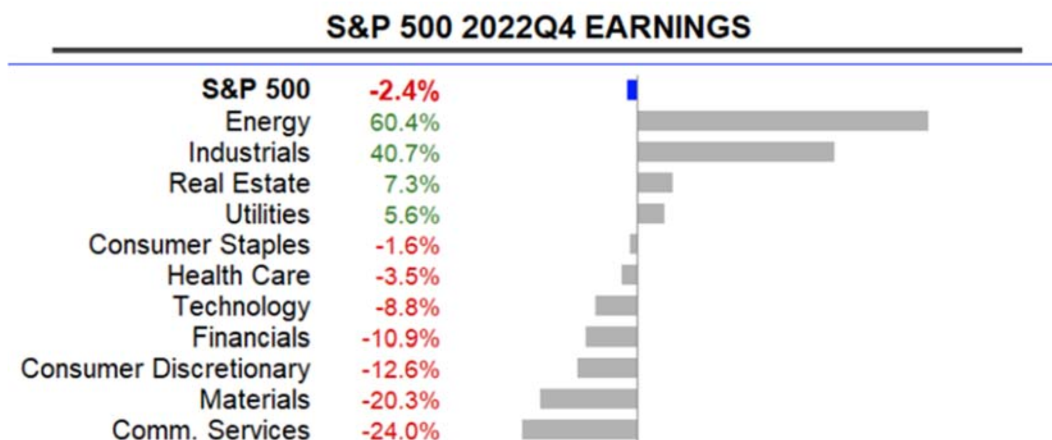
*The reopening in China should provide some support for the global economy, but not as much it has historically. The global monetary tightening will outweigh the effects and reduce aggregate demand*

*Specialist Long/Short Equity managers, notably in the energy transition space, gave a more positive outlook. The tailwind from the US Inflation Reduction Act and the urgency to improve energy security in light of the Russian-Ukrainian war are a beneficial to their investment universe.*

*In this scenario Long/Short Equity managers are confident that they will find opportunities on the long and short side and believe they can out-perform the market as in 2022.*

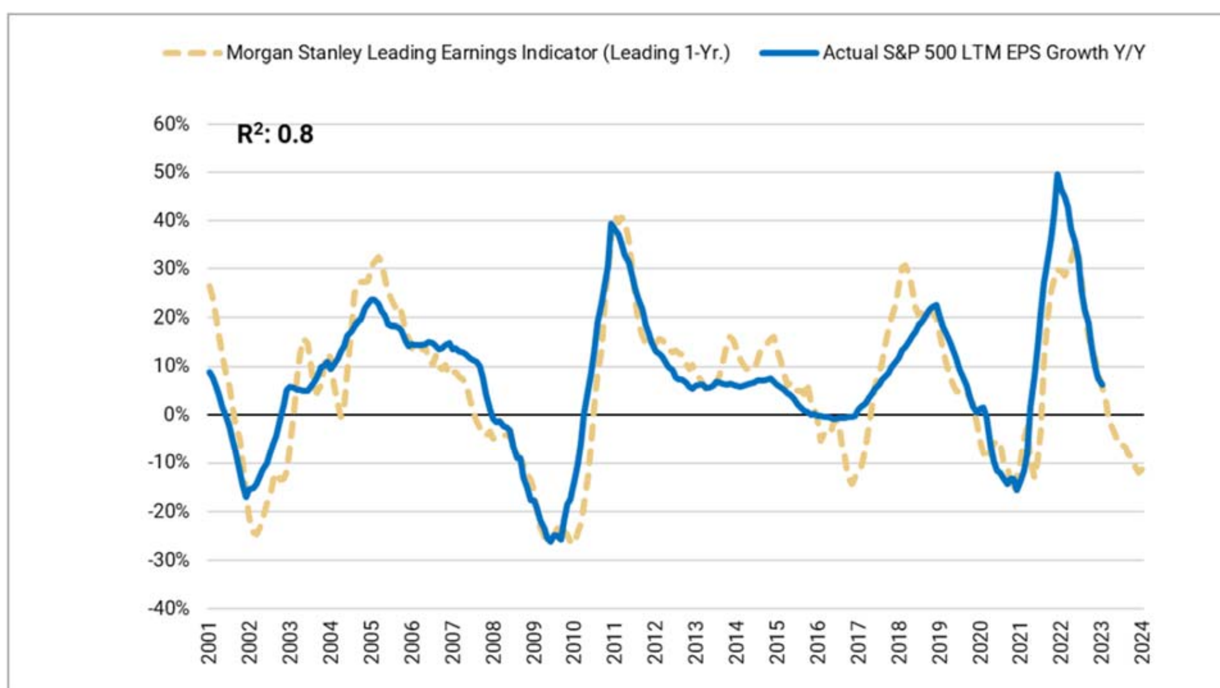
## Market Observations

Corporate earnings growth is expected to slow in the year ahead in many countries as higher inflation and rising interest rates take an even bigger toll and companies brace for the likelihood of a global economic downturn. S&P 500 fourth-quarter 2022 earnings now are expected to decline 2.4% year on year, which would be the first quarterly earnings fall since the third quarter of 2020, according to IBES data. If the energy sector is excluded, the growth rate for the index is -6.6%.



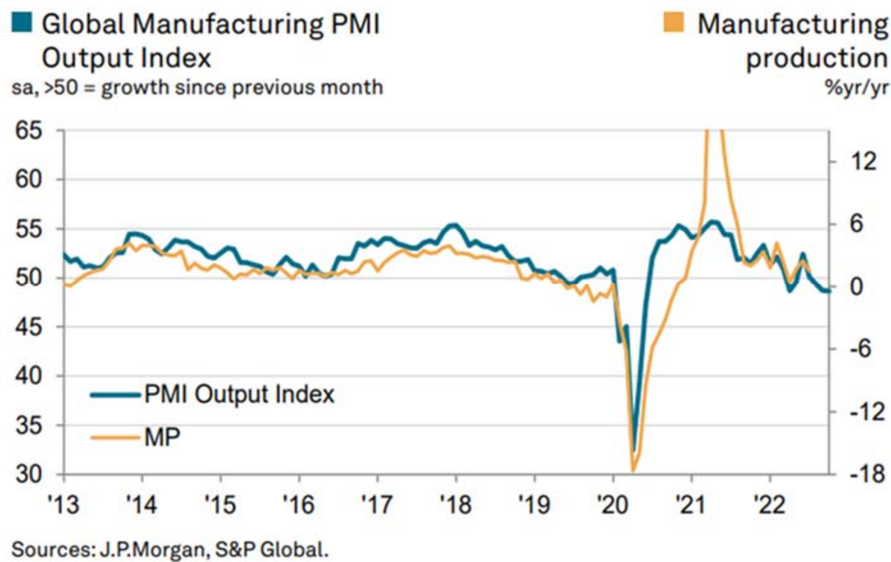

Refinitiv S&P 500 Earnings Scorecard (Feb 2, 2023)

Recent signs of slowing inflation have not brought any confidence yet that the fight has been won. Cost growth is rising faster than the sales growth for about 80% of S&P 500 industry groups. Marging pressure is leading to negative EPS growth.

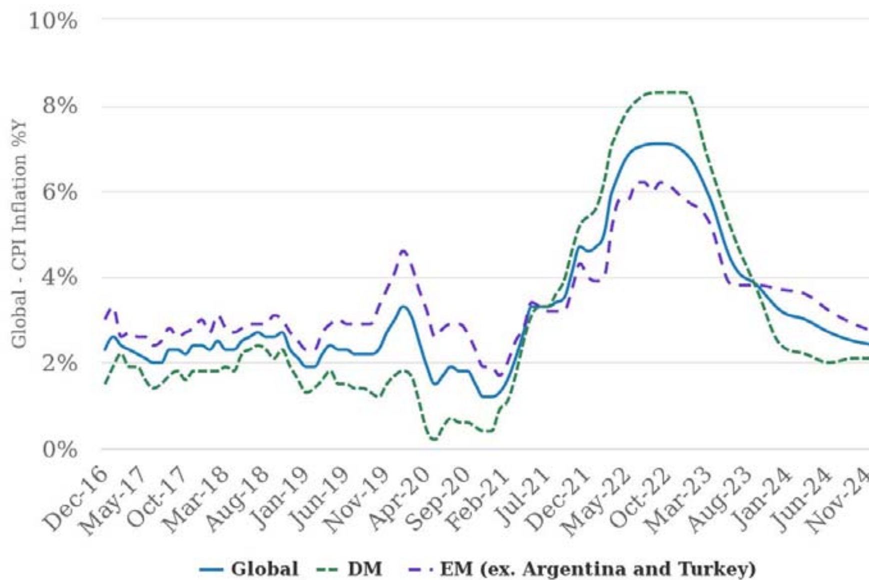



Morgan Stanley US Equity Research (Feb 3, 2023)

The Federal Reserve have indicated it will deliver more interest rate hikes next year even as the economy slips towards a possible recession. Fed Chair Jerome Powell has argued that a higher cost would be paid if the U.S. central bank does not get a firmer grip on inflation.




In the current outlook, most market participants expect another two (possibly three) rate hikes by the Fed in Q1 2023. Early signs that this could be enough to cool the economies and slow inflation.

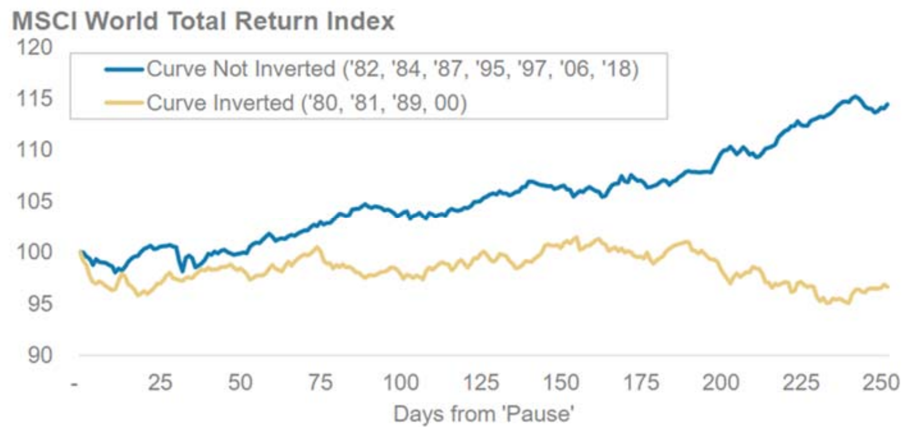



Source: Haver Analytics, Morgan Stanley Research forecasts

Cross-asset returns tend to be good after the last Fed hike. But global equities have done worse when the pause happens with an inverted yield curve. Since 1980, cross-asset returns for stocks and bonds are good (i.e., above average) going into, and coming out of, the 'last' hike in a Fed tightening cycle.

But this average masks variation. Equity returns are worse when the curve is inverted: Average 12-month equity returns were ~15% in seven 'pauses' that occurred with a positively sloped 2s10s Treasury curve. But they were -3%, 18pp worse, under four that happened with an inverted curve (1980, 1981, 1989, 2000). A flat but positively sloped yield curve is most consistent with a soft landing, implying that Fed policy will stay steady and the economy will continue to expand. An inverted curve suggests that the market expects a sharp change in the Fed's course and is more consistent with fears that the economy will slow sharply going forward.

**Exhibit 1:** Pause effect varies based on whether the curve is inverted or not




Source:: Bloomberg, Morgan Stanley Research

A well-constructed short book will provide additional diversification and returns in a falling and/or sideways market.