RUBRICS

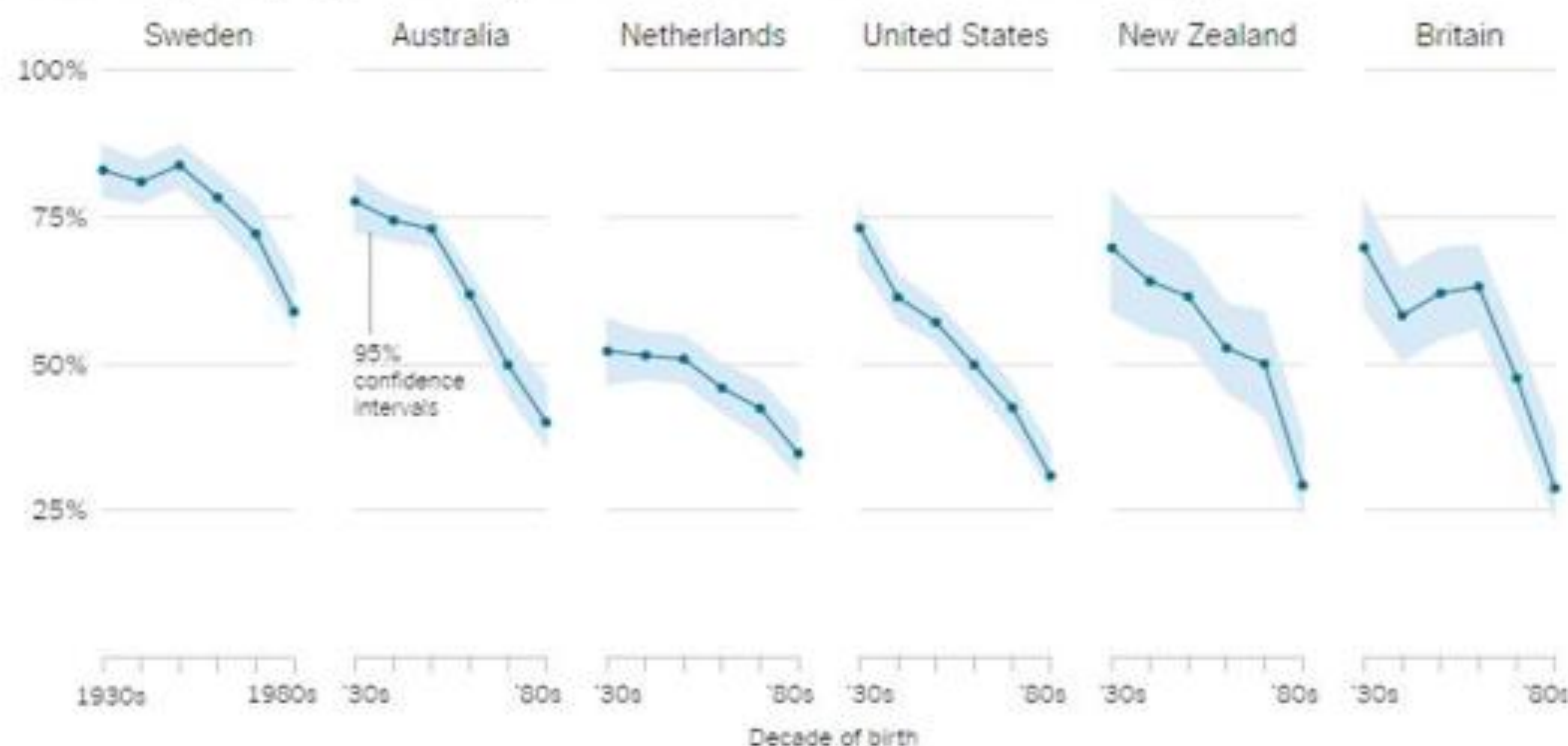
2023 Outlook

Fixed Income Macro View

rubricsam.com

Big Picture Reset

1. Stability Breeds Instability



Have changes in living standards since boomer generation impacted broader political leanings?

Source: FT as at 31/12/2022

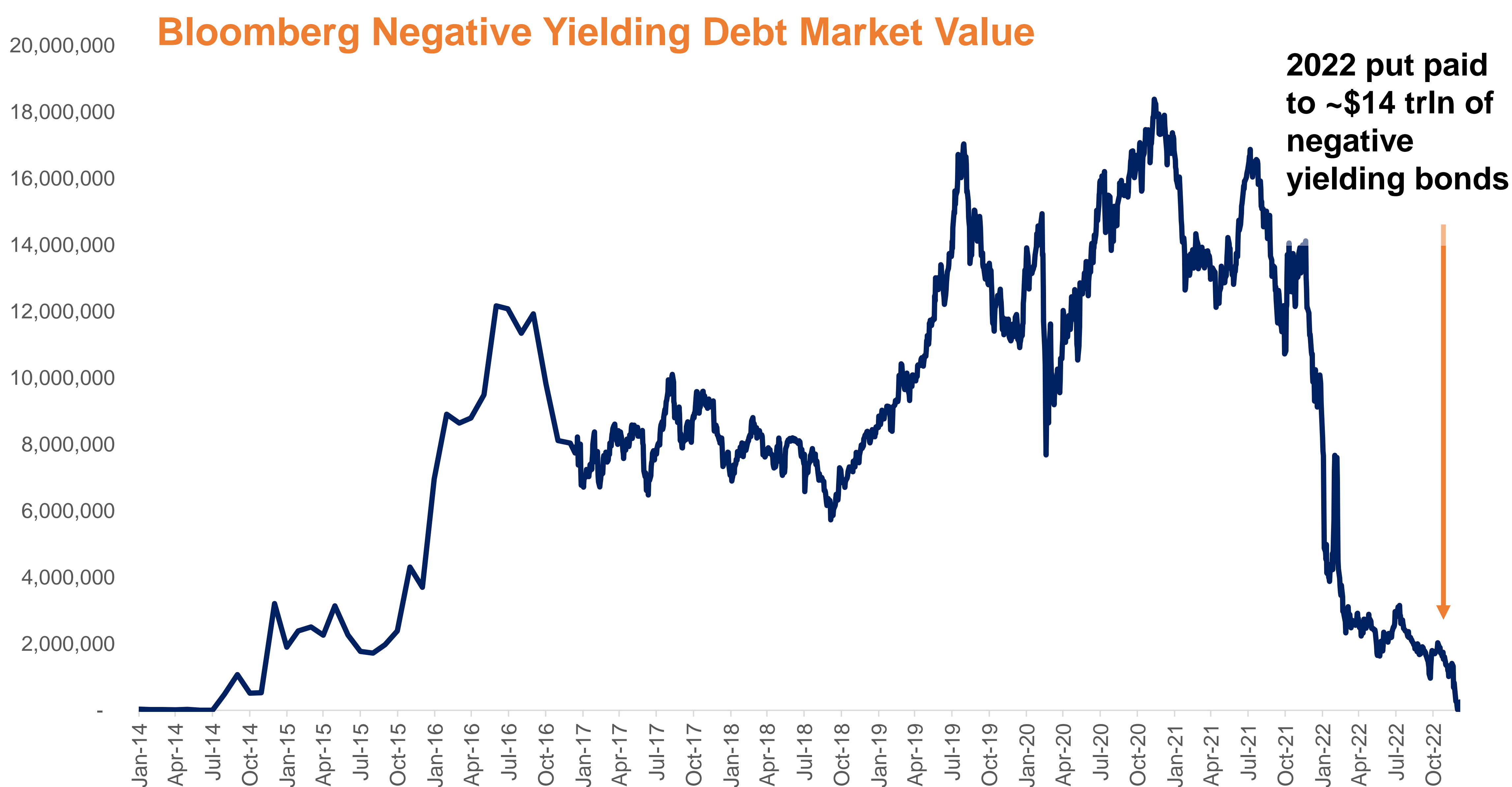
Every great era of economic and political dominance inevitably comes to an end. Each period's strength eventually gives rise to its weakness, as the marginal returns are gradually whittled away. Today's two largest economies are both suffering from diminishing returns of what were once powerful economic engines. While the so-called end can be protracted, the point of no return is reached once the social contract with the electorate is broken. Change becomes inevitable - by force or otherwise.

As we have mentioned in previous notes, post 2008, the benefits of the Neoliberal system have been enjoyed by a disproportionately low cohort of society. This trend continued until the middle of the last decade, when the first signs of disruption (in the developed world) reared their head in the form of Brexit and Trump. Enough was enough. However it wasn't until Covid hit and the ensuing aftermath that the speed of change accelerated. 2022 was the year that financial markets finally bore the brunt of shifting political and economic winds. This volatility will be with us for a while yet until global economy settles on a new equilibrium. However with this uncertainty comes great opportunity. 2022 was a watershed moment for financial markets as they finally awoke to a new reality, one which should (eventually) encourage productive investment over speculation.

2. Shifting Tectonic Plates

The world, for the past 40 years or so, has lived through a period of extraordinary financial asset inflation. When considering the level of accompanying real underlying economic activity, this move is all the more remarkable. Such things do not happen by accident. Overarching political and economic ideologies create the environment in which economic activity, social cohesion and asset/financial market performance thrived.

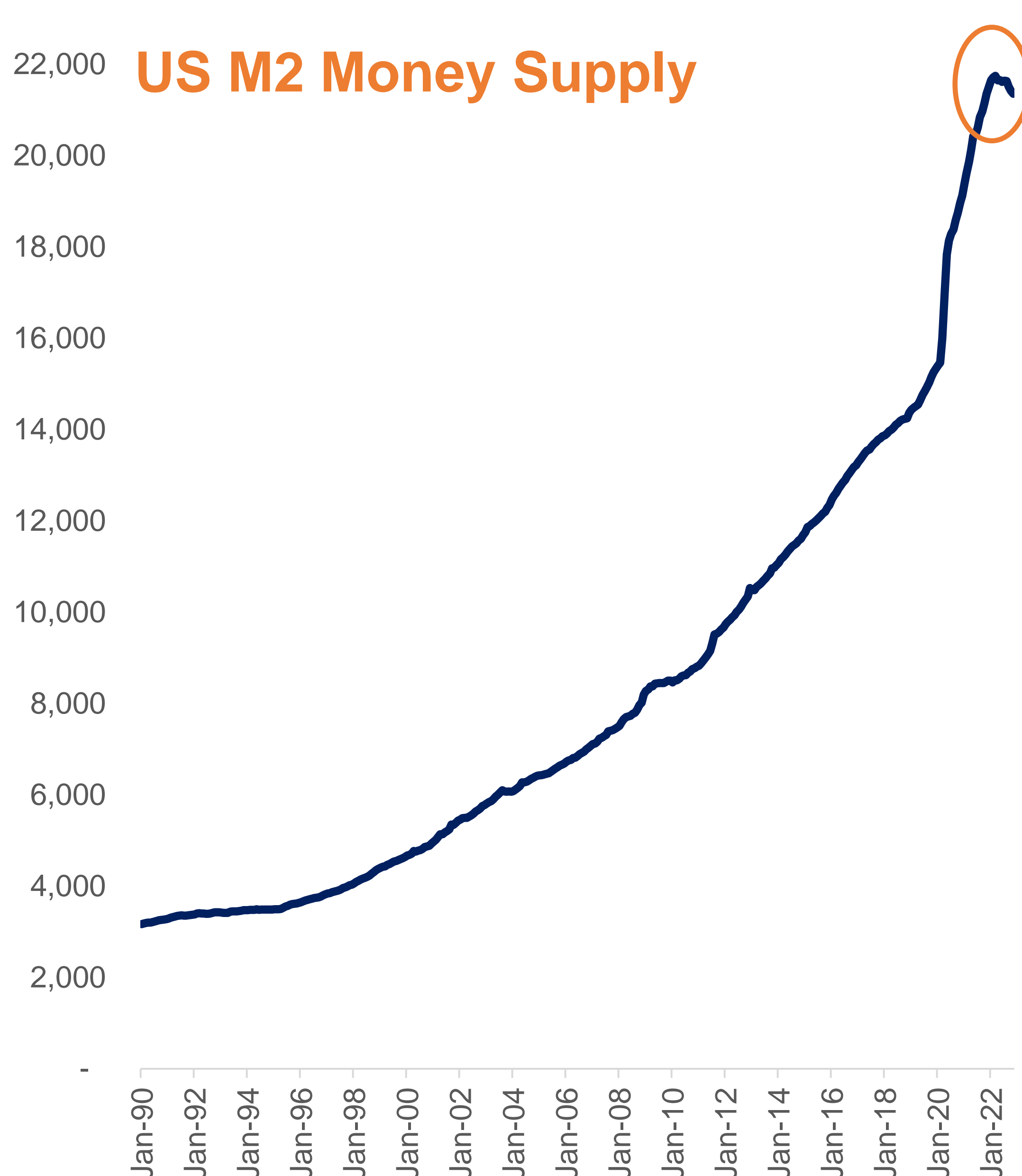
Structural forces in the form of a benign geopolitical backdrop and technological advancements also played a significant role, principally by dampening 'real world' inflation in the developed markets. This helped justify decades of ultra loose monetary policy of which financial asset prices were by far the biggest beneficiary. As some of these bigger macro trends have begun to unwind, the process of repricing inflation and rate expectations has begun. 2022 was the moment where asset prices began to grasp this new reality.



Source: Bloomberg as at 31/12/2022

2. Shifting Tectonic Plates

The 2020s have seen the emergence of a series of 'unforeseeable' events. But just how unforeseen have they been? While few could have predicted a global pandemic in late 2019, the likelihood of such an occurrence was openly discussed since the SARS outbreak in 2002/3. Meanwhile an outbreak of inflation had been predicted by many since the GFC while labour market changes driven by demographics have been spoken about ever since the rise of the baby boomers. As regards geopolitics, Russia was flexing its muscles around eastern Europe unhindered for years as China was increasingly following its 'China first' policy. All the while low inflation was the glue that kept the show on the road. The positive economic momentum that was generated over this period was significantly augmented by an explosion of the monetary base. However few understood the structural reasons underpinning this benign environment (although central banks gladly took credit for it) and the potential long-term costs of prolonged monetary easing were summarily ignored.



Source: Bloomberg as at 31/12/2022

Looking ahead, although the fallout from the Russia/Ukraine conflict seems limited to the energy markets, a further escalation of the war is possible if Putin becomes more desperate. As regards further geopolitical discord, China continues to antagonise the West through its support of Russia as does Iran. Israel meanwhile has elected the most right-wing government in living memory. The world is breaking into sides and building a more abrasive military stance (Japan, Australia etc) - with tensions clearly on the rise.

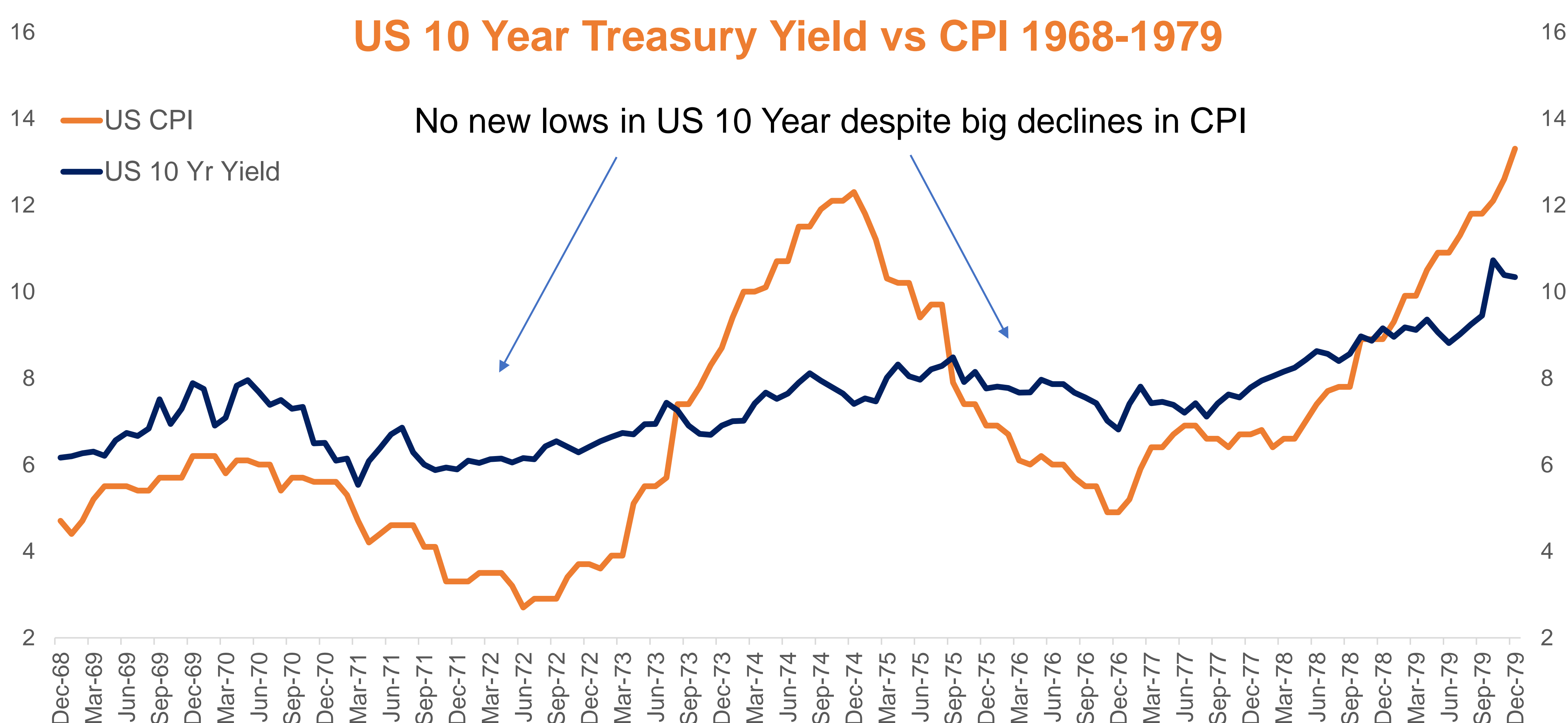
3. Inflation at the Epicentre of Change

Aggressive monetary policy by its very nature creates a certain type of inflationary pressure - that of increasing financial asset prices. The response to the pandemic saw a dramatic departure from this playbook - a forceful fiscal approach not seen since the end of the New Deal order in the 1970's. The combination of fiscal (demand-led) with supply side constraints significantly shifted the inflation dial in from its multi-decade malaise. The emergence of friction around the level of global trade (Russia/Ukraine, China) meant that the inflation genie was well and truly out of the bottle. Not the transitory pandemic-led kind, but structural, and underpinned by both political and economic forces. While one aspect of the early inflation outbreak subsided, other areas took over as price increases moved from goods to services which drove up the cost of living substantially – allowing corporates to push prices even higher. While the more transitory elements of inflation have begun to recede, many of the stickier, structural items have not. Despite growing optimism that the peak in inflation may be behind us, Central banks remain worried about the potential for a wage price spiral to take hold which can prolong the inflationary problem.

Source: Bloomberg as at 31/12/2022

3. Inflation at the Epicentre of Change

While each economy has its own unique set of circumstances, with central banks approaching the problem at different speeds, there are a also uniform set of underlying factors at play (as aforementioned). The world got smaller all of a sudden. As we saw throughout the 1970s, inflation is a volatile beast and it will not be easy to predict when the battle is won. What we do see now is an acceptance that the 2% inflation target is flawed, along with the realisation that we are shifting to a new paradigm where trend inflation will be higher despite periodic outbreaks of outright deflation (debt overhang will play a role here).



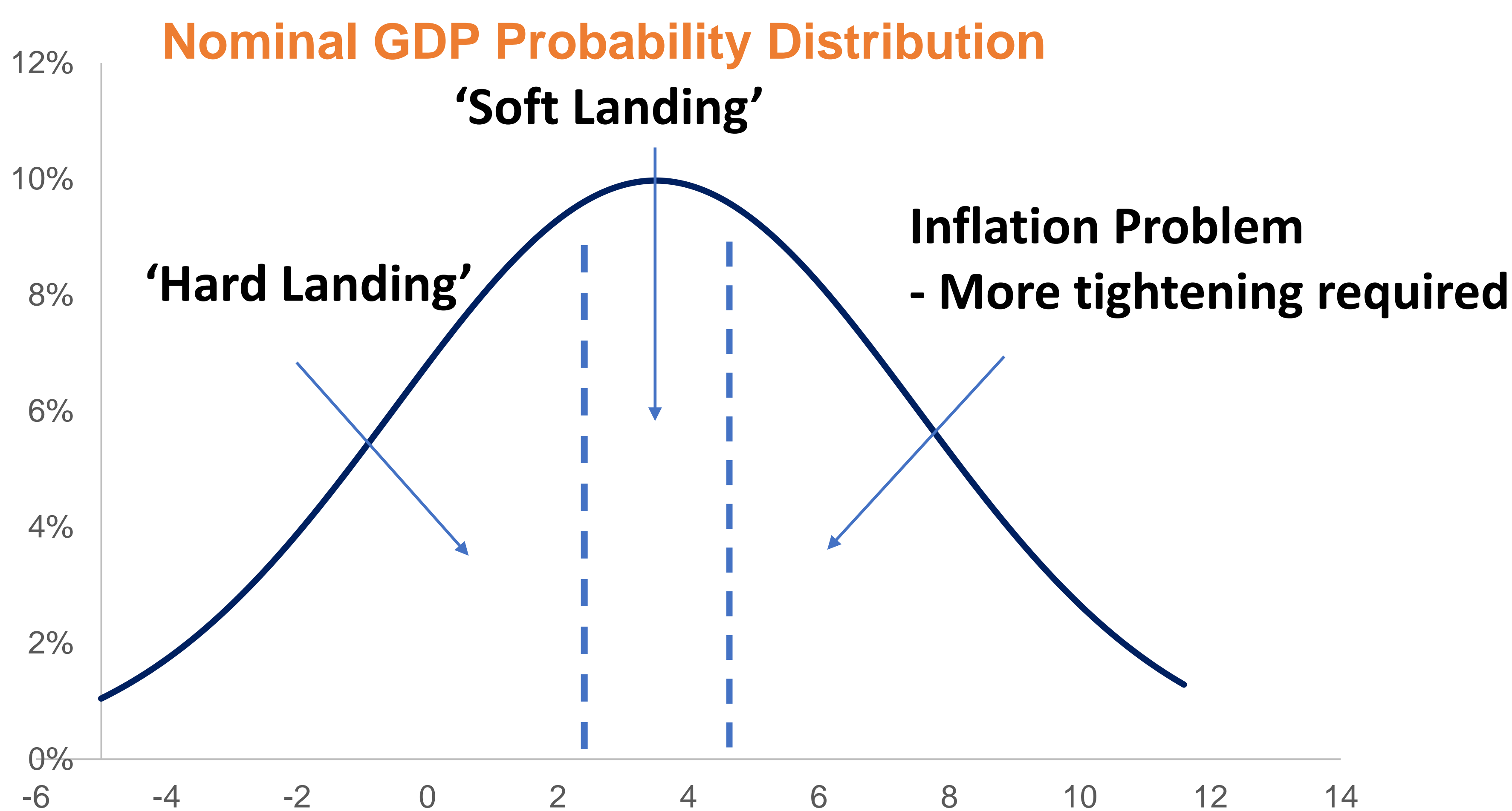
Source: Bloomberg as at 31/12/2022

Perhaps the greatest turnaround in thinking has been seen amongst the Central Banks and their stance on inflation. In 2021 inflation was nothing more than a transitory phenomenon that would quickly disappear, until 2022 when it became an existential crisis which could only be fought with Volkeresque vigour. This flip in mindset, yet to be fully appreciated by the financial markets, can change dramatically the nature of financial markets and the broad over-reliance on cheap credit.

Economic Roadmap

1. The Growth/Inflation Pendulum

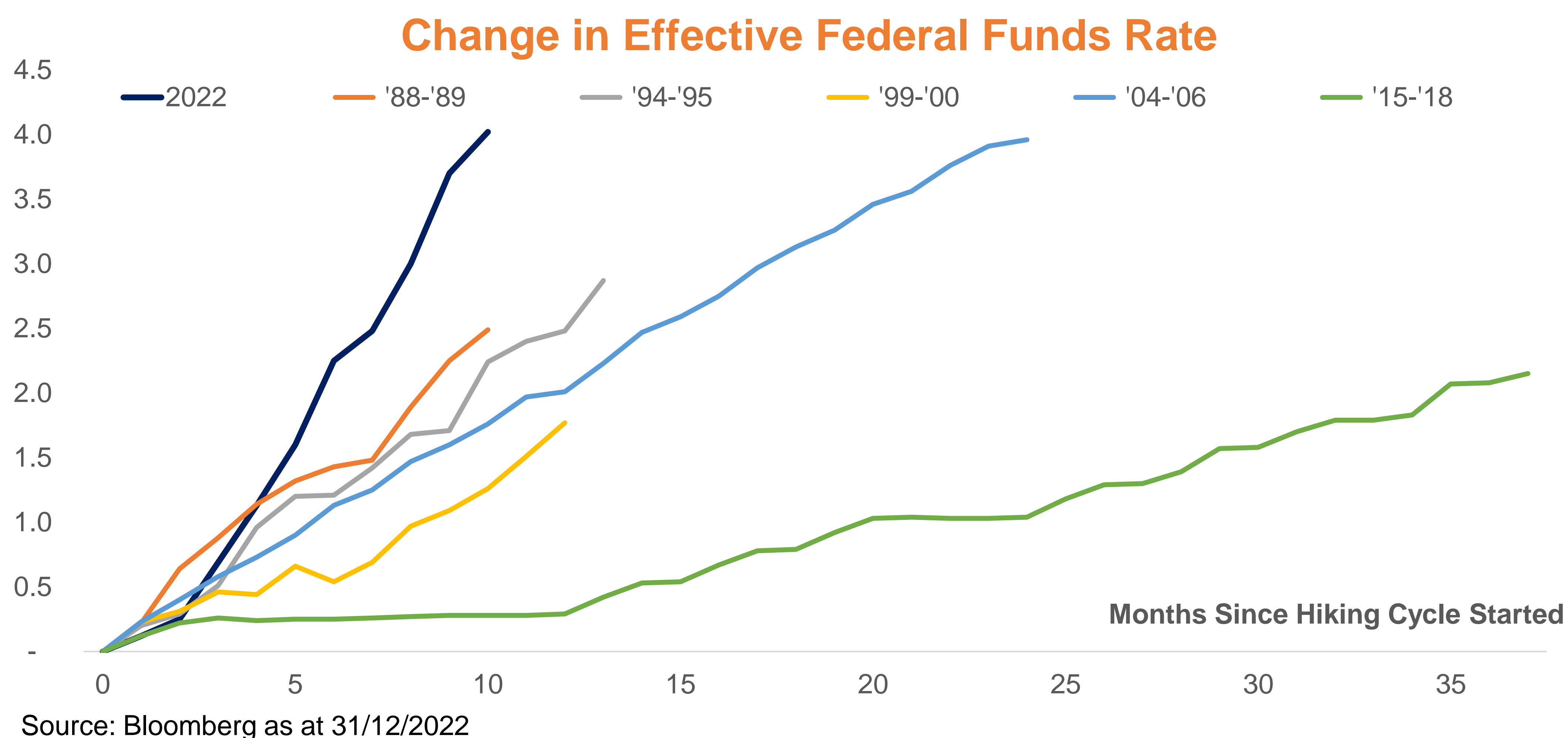
There is continued optimism that inflation will fall back to a generally acceptable level over the course of the next year. Buoyed by recent economic data, this view represents a current consensus among the investment community and is the linchpin of the soft landing narrative. While it may be a plausible outcome, the possibility of either a nastier recession or a continued inflationary problem is more likely in our view.



Source: Rubrics as at 31/12/2022

As to which of the two 'fat tail' outcomes will materialise is a more difficult question. Recent releases from the Fed suggest an acute awareness of the likelihood of tightening becoming restrictive. Could this lead to a premature easing and a prolonging of the inflationary problem? Possibly. The counter argument suggests that despite the inflationary surge in 2022, the current aggressive tightening stance of global central banks has skewed the real risks towards a growth shock. It is hard to get away from the unprecedented nature of global indebtedness and the speed and trajectory of recent rate rises (and QT). The prolonged proliferation of cheap credit throughout the last cycle will surely come home to roost (eventually), which will have the potential to alter the psychology of the economy and consumers. This however does not mean a return to pre-pandemic inflation trends anytime soon.

1. The Growth/Inflation Pendulum



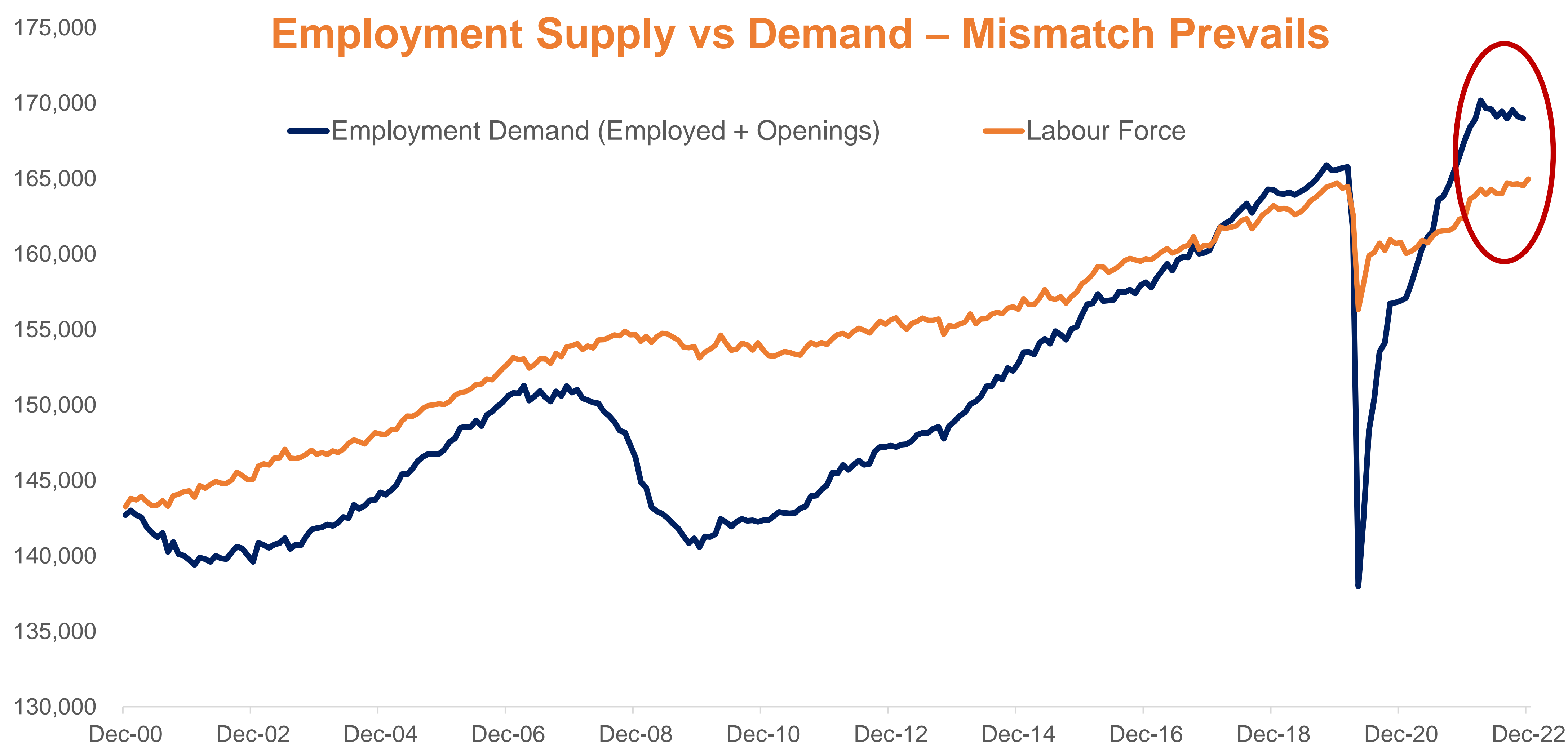
Source: Bloomberg as at 31/12/2022

Given the time lag of monetary policy it won't be until the second half of 2023 that we see the full consequences of this sudden normalisation . While it is true that much of the risks have been transferred from a handful of systemically important global financial institutions to millions of investors across the institutional and retail spectrum, it is difficult to believe that the less liquid parts of the investment universe won't come under real pressure. In particular those areas that have been exposed to the most aggressive lending practices of the last decade -shadow banking/private credit/equity. The extent of the spill-over from this to the broader financial system is at present one of the greatest 'known unknowns'.

From a broader economic perspective, the housing market represents the channel through which households are feeling the pain of rising interest rates, especially those with floating or shorter term fixed mortgage exposure. Certain economies are more susceptible in this regard and the US with its fixed term mortgage structure is more insulated than many markets elsewhere. Longer term it remains to be seen if the inevitable decline in consumption can be matched by a real jump in investment and productivity to offset the increased living costs.

2. Labour Market – The Pivotal Data Point

Looking ahead, the single most important factor that will define our economic outlook is the labour market. This will have a pivotal impact not only on growth but inflation as well. While the factors driving the latter can be seen from a straightforward cyclical and indeed structural viewpoint, the labour market is more difficult to predict.



Source: Bloomberg as at 31/12/2022

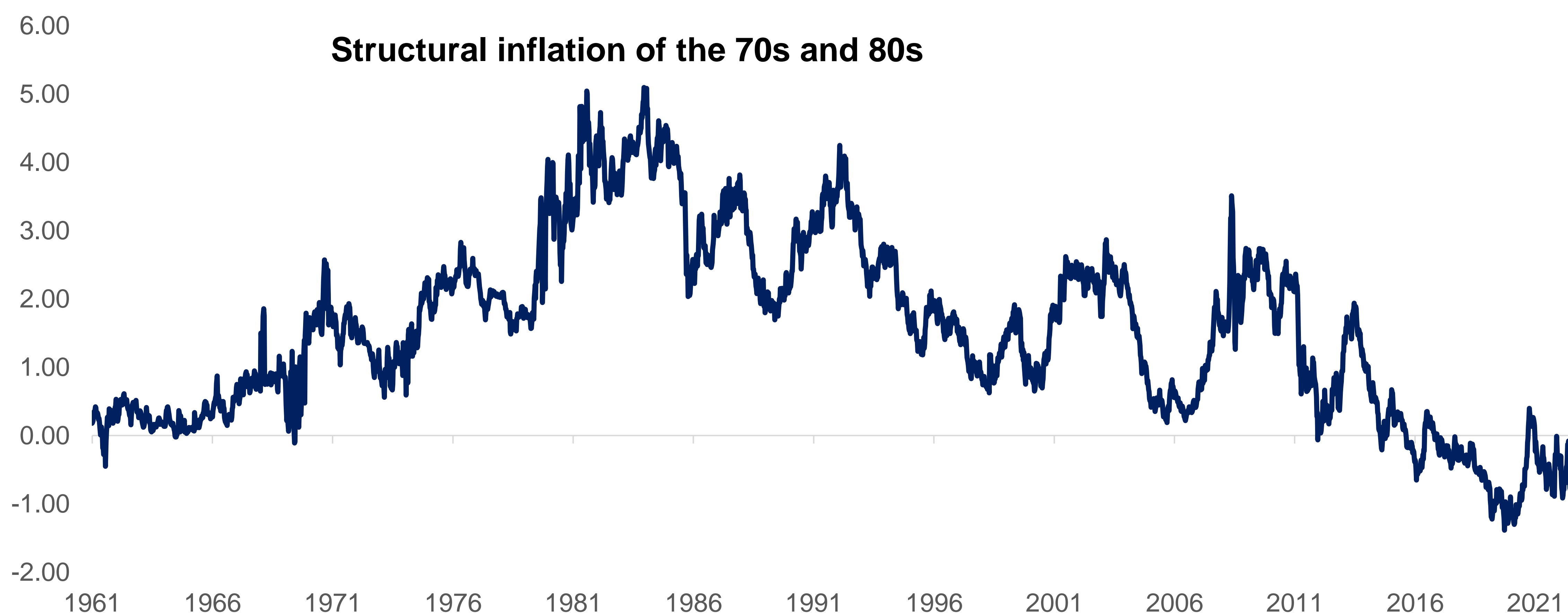
In the US, participation rates continue to fall even as wages have improved. Demographics are surely playing an important role here as baby boomers hit retirement age. In addition, the numbers of long term incapacitated have risen to alarming levels since the onset of COVID. The upshot of this has seen job openings remain plentiful – so much so that some employers are holding onto employees longer than they would ideally like (heading into a downturn) due the difficulty securing good staff. That being said, there are certain signs of jobs market weakness in the declining Quits and JOLTs rates, for example. Anecdotally, stories abound of employers making large layoffs. With soft economic data showing signs of real weakness, the labour market represents the last 'shoe to drop' so to speak in the Fed's tightening narrative. Watch this space.

Fixed Income Outlook for 2023

1. Bond Market Outlook

Today's bond market can be broken into two – the interest rate sensitive portion and the growth sensitive area. The latter will ultimately be impacted by interest rate normalisation, but that comes later. The rates market has repriced and offers real and tangible opportunities for strong risk adjusted returns. Against this, the growth sensitive portion of the market has yet to fully adjust pricing to compensate for upcoming economic risks. The ultimate outcome of this will be for nominal rates to stay positive (real rates will still be constrained but closer to zero) and the term premium of the bond market we expect should shift higher as we saw in the 1970's into the 1980's.

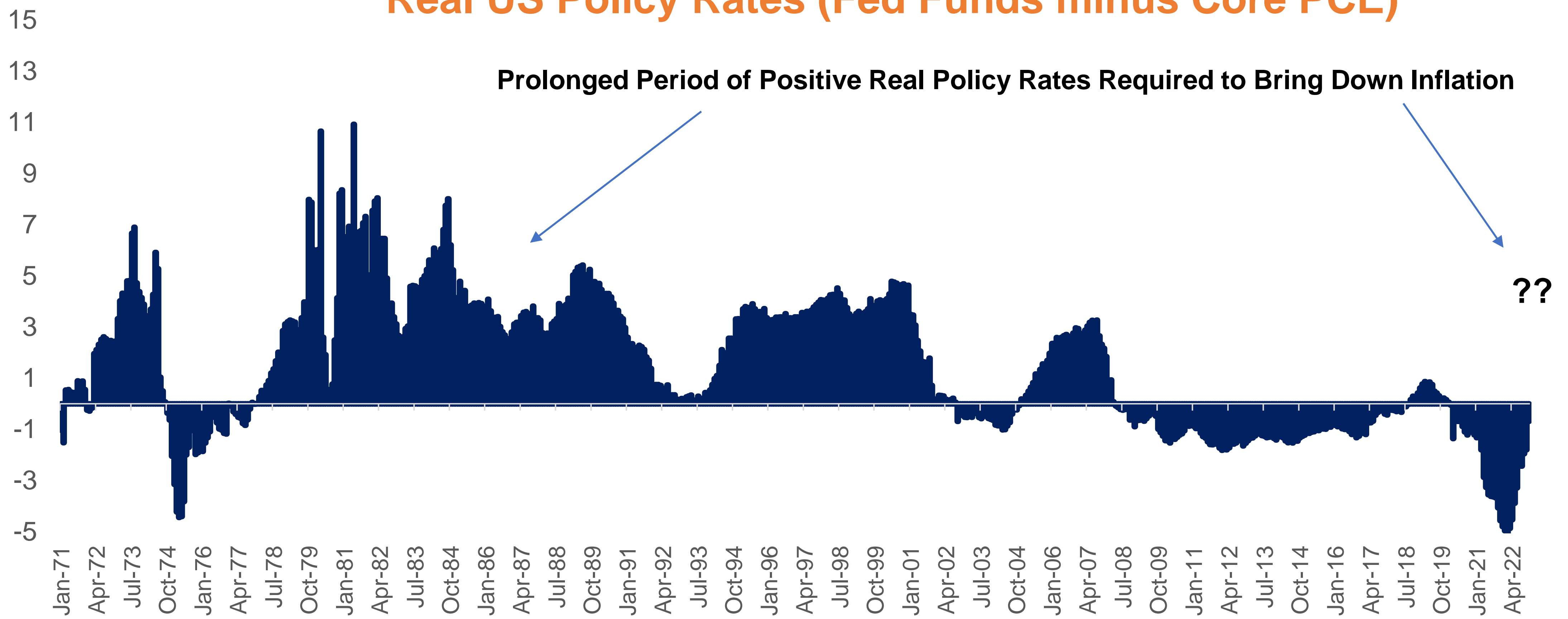
10-Year Treasury Term Premium



Source: Bloomberg as at 31/12/2022

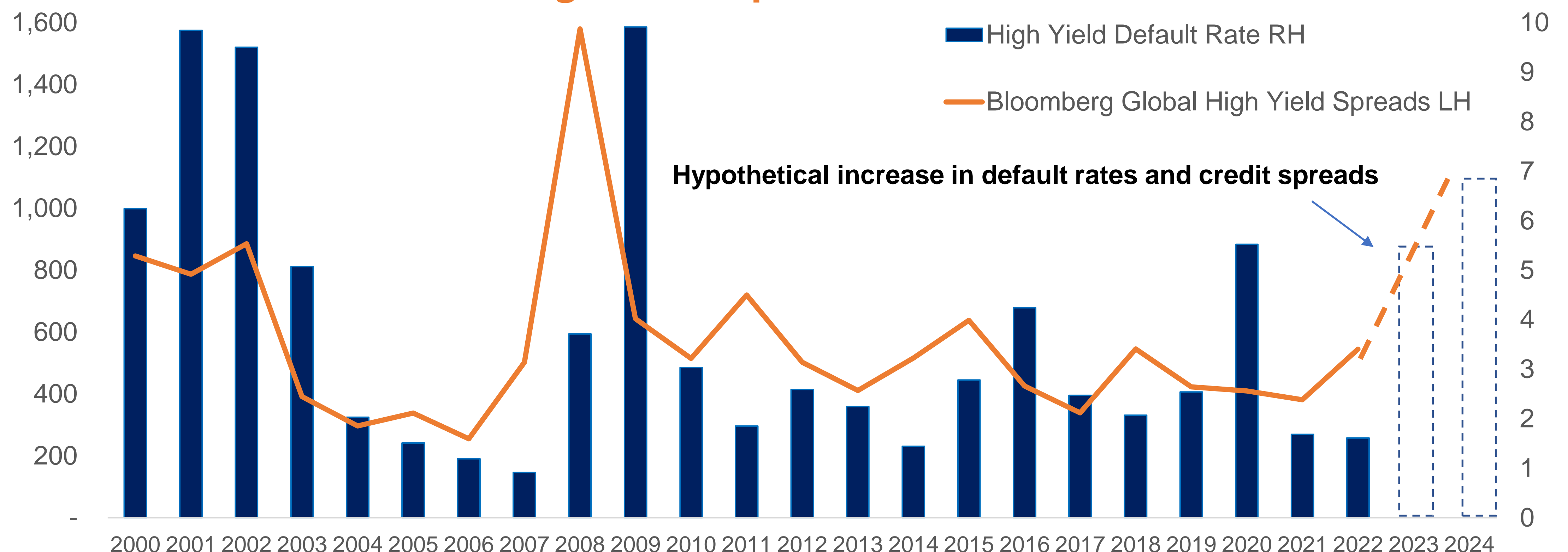
These developments also promote the idea that investors will ultimately demand shorter duration investments. The markets had a similar profile of term premium in the late 1960's as today, as inflation at the time was deemed to be merely transitory according to Fed Chair Arthur Burns. Over time this relaxed view of inflation began to break down. With a new era of policy making (fiscal) and structural constraints (labour market) and growing demands (health care) we may just be in line for a similar outcome over the next few years.

1. Bond Market Outlook



Source: Bloomberg as at 31/12/2022

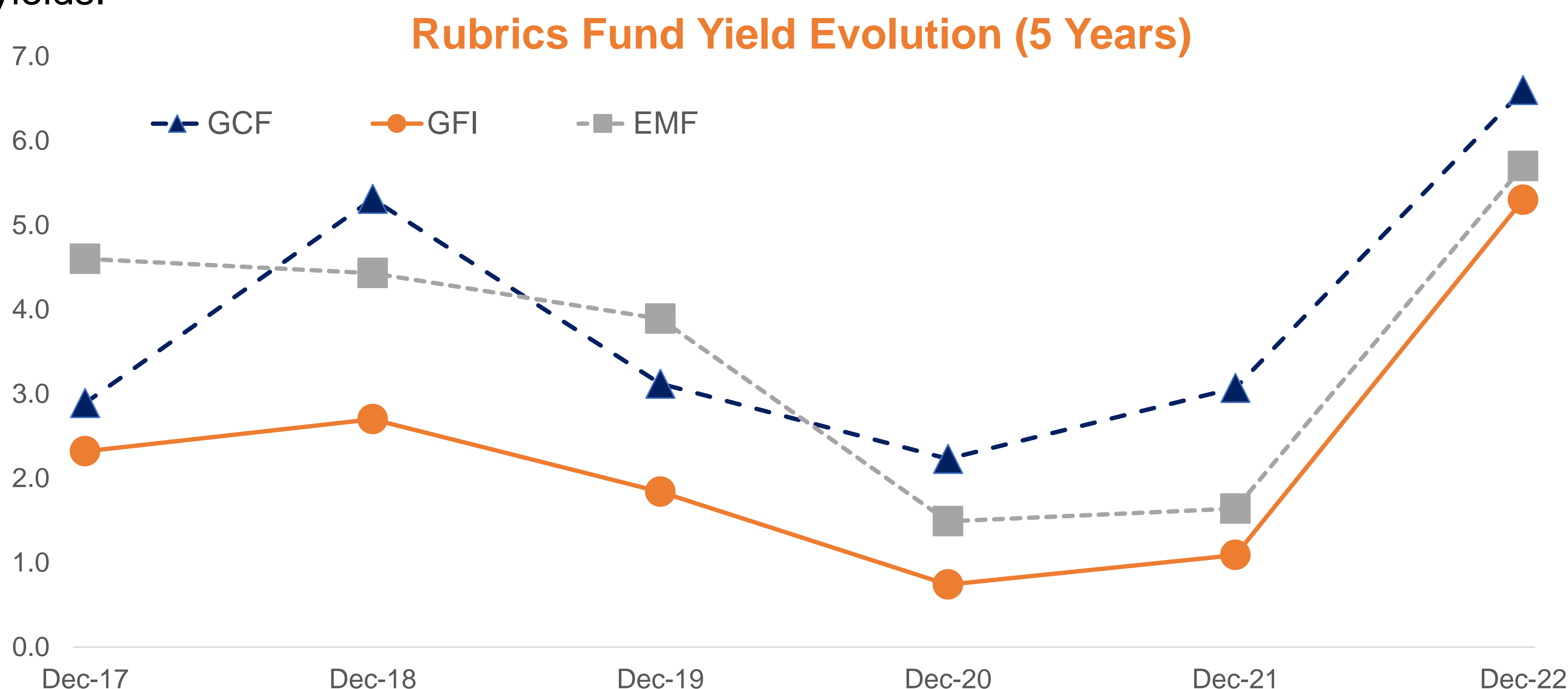
Many feel Central Banks will overdo the rate hikes in fighting a battle they believe is already won. History, however tells us that it is far too early to declare victory. As Powell stated a few months back, it is easier to recover from doing too much than too little. We would therefore expect the Fed to continue their inflation fighting rhetoric for at least the first half of 2023. While rate cuts are priced into late 2023 we believe it is too early for this to materialise and would look instead to 2024 for the first genuine 'pivot'. Notwithstanding, we would expect negative growth to impact credit markets with an increase in both defaults and credit spreads – the latter peaking in advance of the former.



Source: SP Global as at 31/12/2022

2. Higher Yield - Lower Beta

The pain of the 2022 repricing of interest rates will potentially be matched by 2023's repricing of growth. This year will give us a much clearer picture of where the new world of normalised monetary policy will stand. Our expectation is that we will see many conflicting signals and lots of volatility, and indeed it might take the full year to understand how the global economy will begin to adjust to so many new structural shifts. As painful as 2022 was, 2023 might in some ways be even more difficult, with the one admittedly big advantage of heading into this period with the comfort of significantly higher nominal yields.



Fund Total Return	2022	5 Year
Rubrics Global Fixed Income UCITS (GFI)	-5.49%	4.37%
Rubrics Global Credit UCITS (GCF)	-8.96%	4.13%
Rubrics Emerging Markets Fixed Income UCITS (EMF)	-3.20%	-1.82%

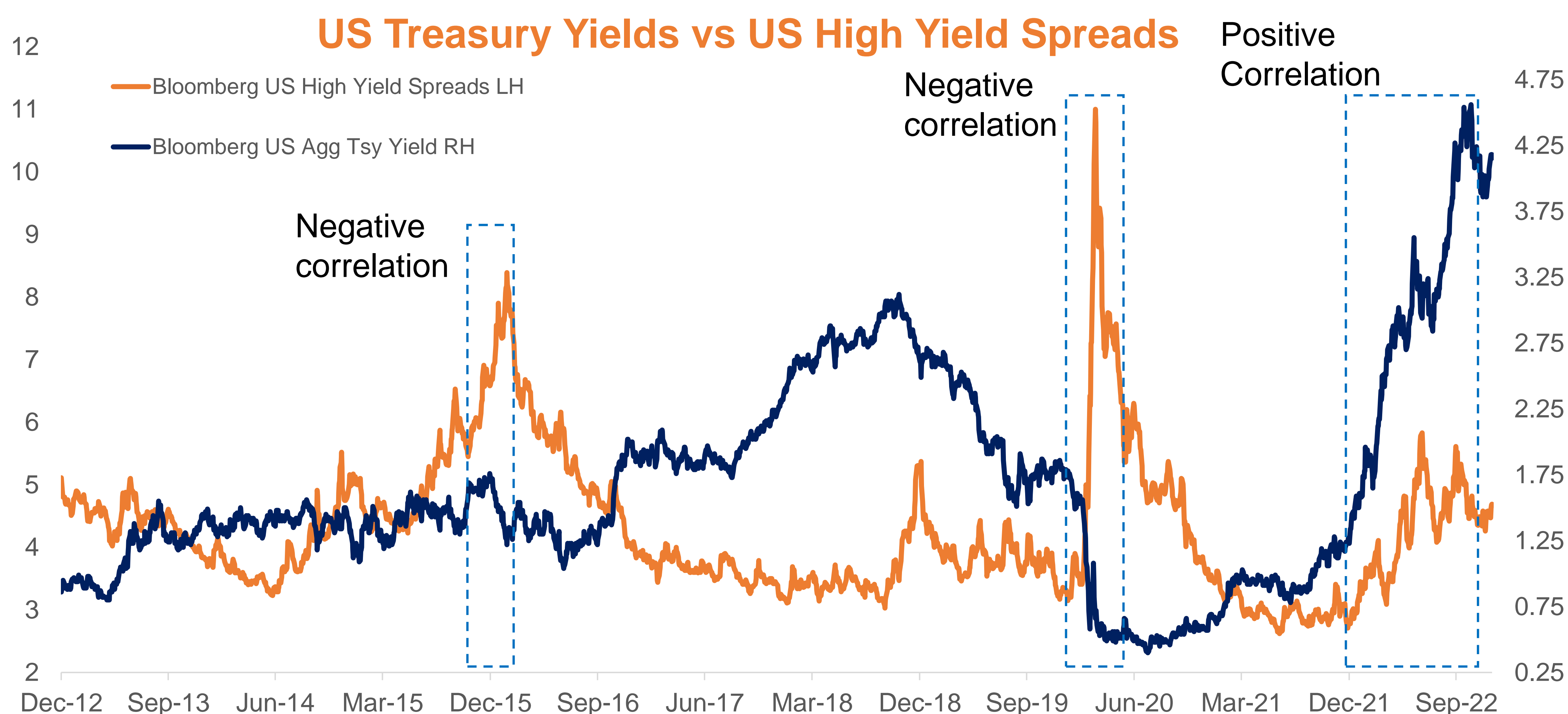
Index Total Return	2022	5 Year
Bloomberg Global Agg	-11.22%	1.79%
Bloomberg Global Agg Corp	-14.11%	2.76%
Bloomberg EM Local Ccy	-10.24%	-7.05%

Source: Bloomberg as at 31/12/2022

In keeping with the investment philosophy, Rubrics has been able to manage the transition to higher yields by preserving capital and outperforming benchmark indices. The focus for 2023 will be to deliver on the higher yields on offer while managing the volatility that can arise with the weaker economic environment - higher yield with lower beta.

3. Credit Strategy

From a credit perspective, we favour shorter duration investment grade instruments which avoid excessive exposure to the more susceptible areas of the credit markets. Given the current level of curve inversion, and the prospect of a recession and a widening in credit spreads, we do not yet see real opportunities in longer duration credit. With correlations between credit spreads and rates remaining elevated, duration at present offers little or no protection against higher volatility in spreads. We would expect this to remain the case until the market begins to price a recession. At this point duration may once again become valuable although our emphasis would be on high quality and favourable liquidity.

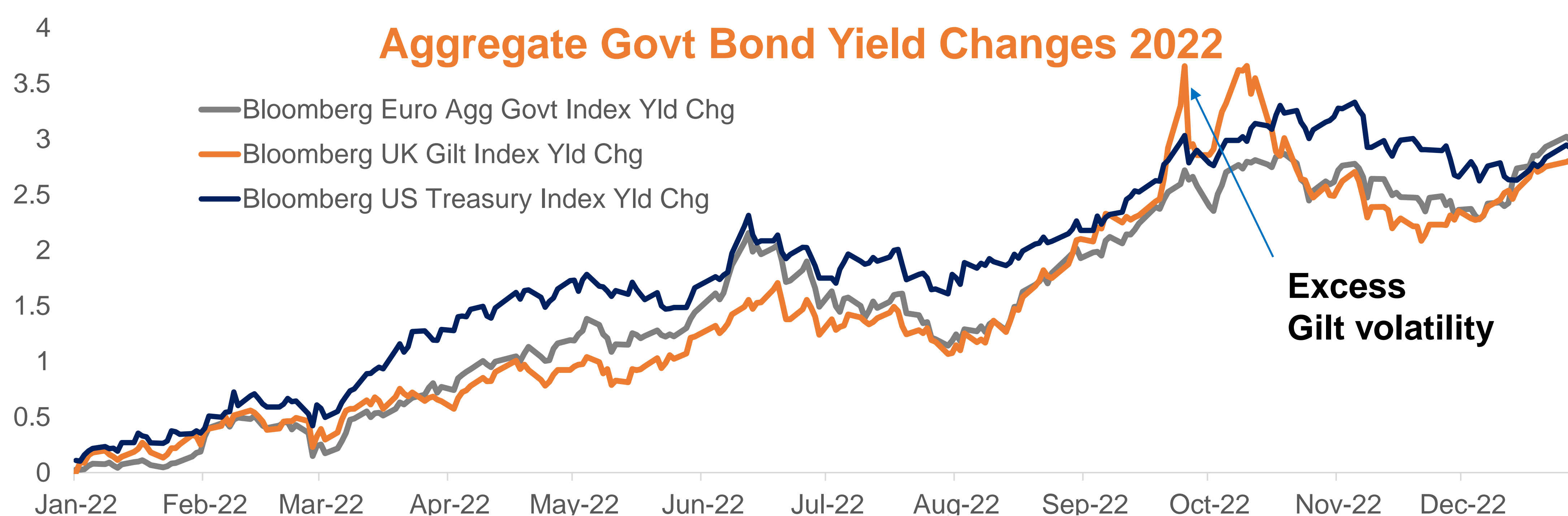


Source: Bloomberg as at 31/12/2022

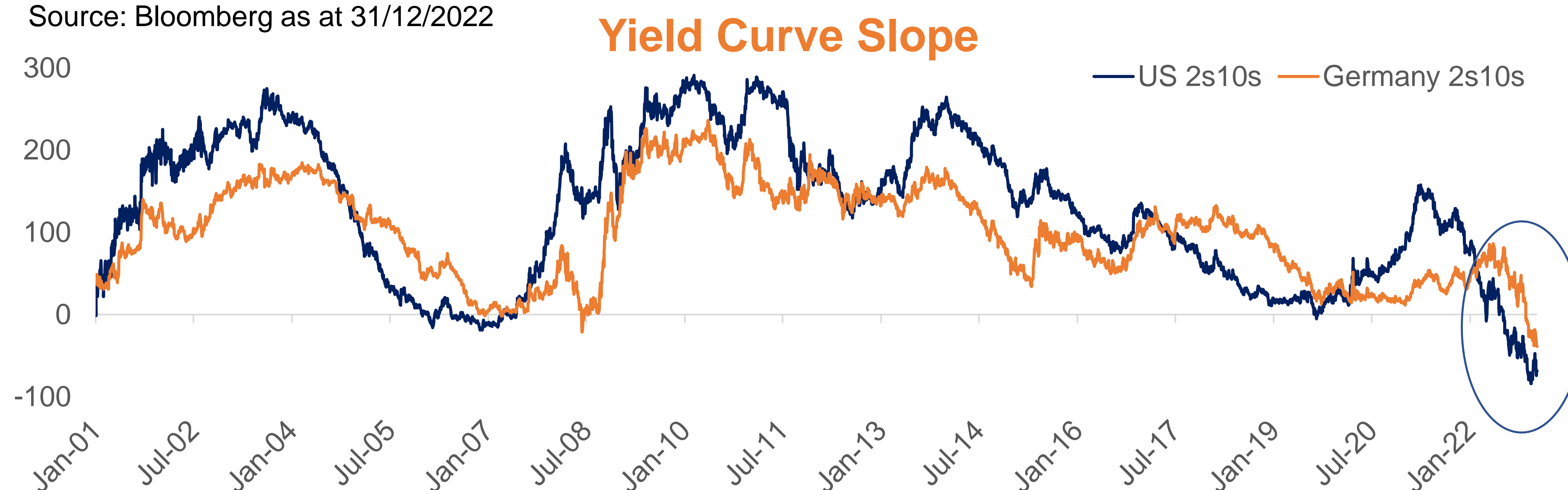
Thematically we continue to prefer strong domestic names with real pricing power. Within this strong domestic banks look attractive as higher rates are helping offset potential for loan losses, while they are also less exposed to global financial market volatility. Avoiding geopolitical risks will be critical as will focusing on names with domestic political support and sectors less exposed to cyclical weakness.

4. Government Bond Strategy

In terms of government bond markets, the US treasury market continues to represent the most favourable destination being the deepest and most liquid. Given the current level of curve inversion, yields at the long end do not provide adequate compensation for risk in our view although there is however the potential for good entry points in future on further volatility (inflation/growth pendulum and/or potential govt shutdown). Against this there are technically supportive factors of excess bank reserves and general market demand. All told the front-end at present represents a more favourable proposition given the higher carry on offer. Elsewhere we would look to avoid peripheral European names for now as volatility and risks will likely remain high. September's Gilt market action in the UK represents a warning in this regard, with structural risks elevated in other markets (e.g. BTP). In addition, balance sheet contraction from the BOJ, Fed, BOE and ECB will also have an impact after a decade of central bank rate suppression. Looking ahead volatility management will be important, with (lack of) liquidity driven rates selloffs a potential area of concern.



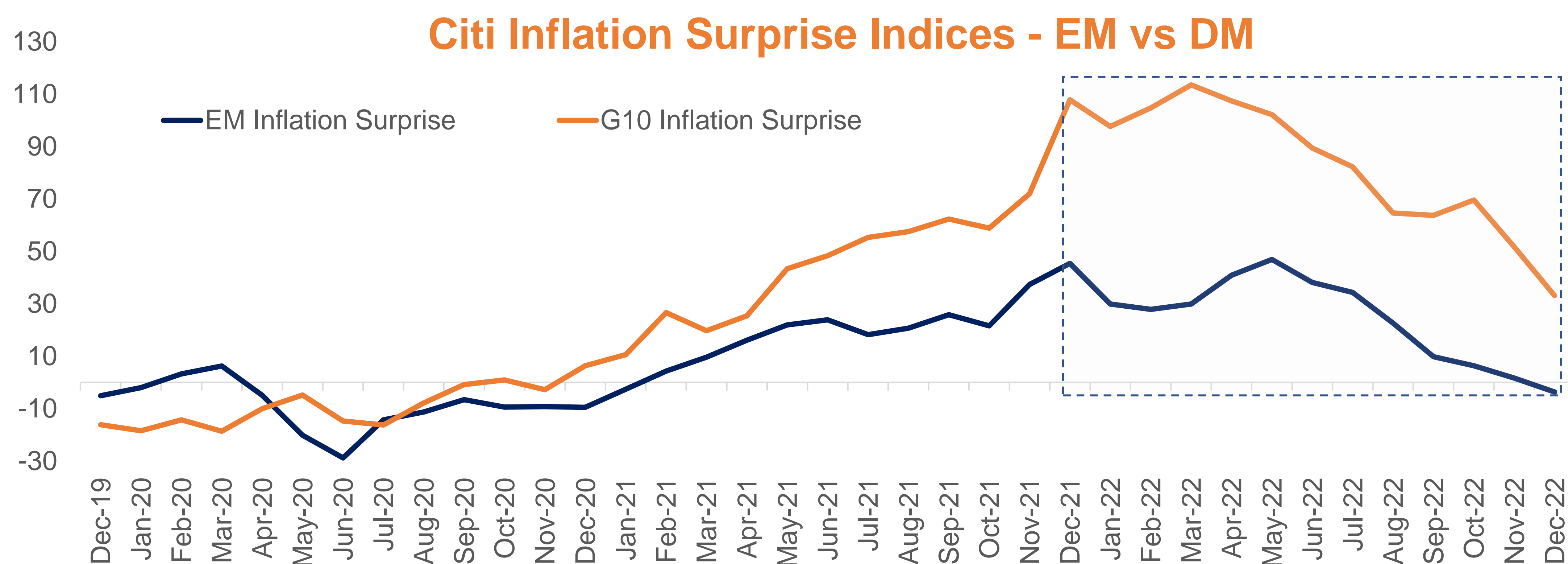
Source: Bloomberg as at 31/12/2022



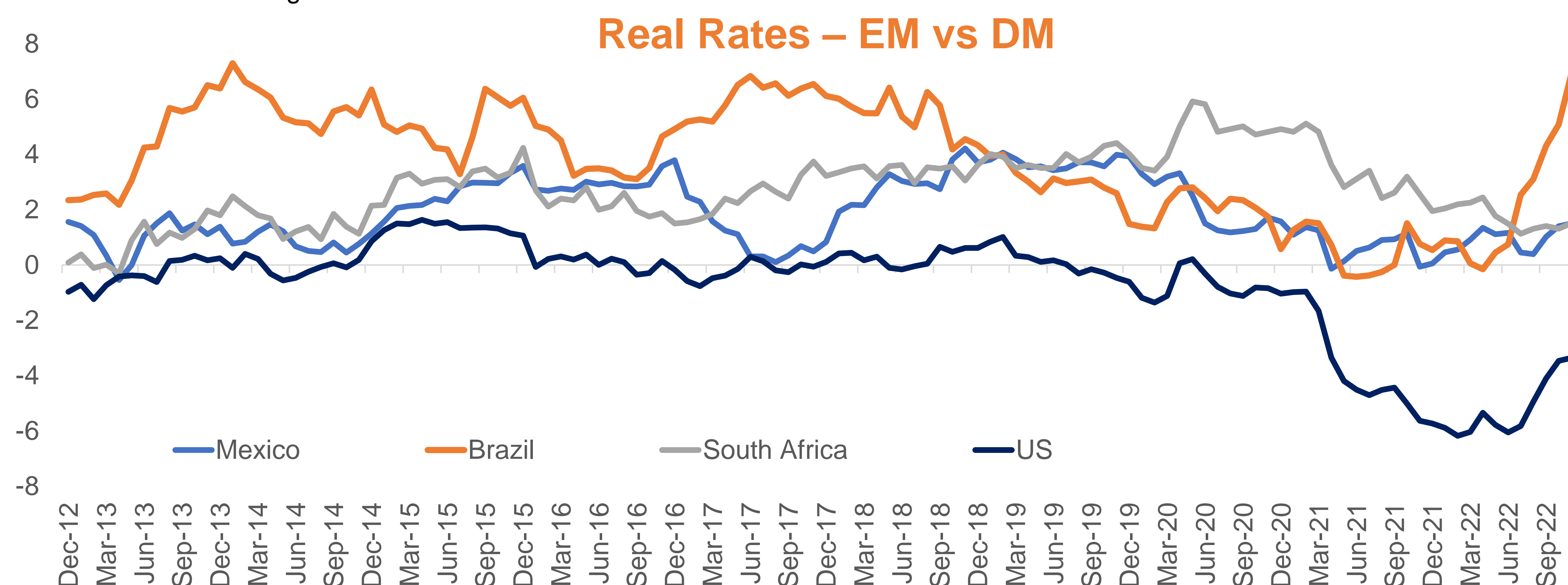
Source: Bloomberg as at 06/01/2023

5. Currency Strategy

The US dollar is a difficult animal to predict with many different factors having periodically driven its directionality. The most clear and obvious catalyst at present is the Fed's tightening cycle. As we come towards the end of this (provided inflation comes down in a sustained fashion), we should see some of the strong USD pressure ease allowing scope for some non-USD stabilisation/appreciation. The other side of the coin so to speak is the fundamentals of the currency in question. We see potential opportunities in those currencies who have managed to get on top of their inflation problems and do not possess outsized growth or geopolitical risks. At present we favour some of the higher yielding currencies in EM for example who offer significantly higher real rates than those available in developed markets.



Source: Bloomberg as at 31/12/2022



Source: Bloomberg as at 31/12/2022

IMPORTANT INFORMATION

Rubrics Global UCITS Funds Plc is a variable capital umbrella investment company with segregated liability between sub-funds; incorporated with limited liability in Ireland under the Companies Acts 2014 with registration number 426263; and authorised by the Central Bank of Ireland pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, as amended). This document is for information only and does not constitute an offer or solicitation to deal, whether directly or indirectly, in any particular fund. Nothing in this document should be taken as an expressed or implied indication, representation, warranty or guarantee of performance whether in respect of income or capital growth. No warranty or representation is given as to the accuracy or completeness of this document and no liability is accepted for any errors or omissions that the document may contain. The Key Investor Information Documents ("KIIDs") and prospectus (including supplements) for Rubrics Global UCITS Funds Plc are available at www.rubricsam.com. The management company of Rubrics Global UCITS Funds Plc is Carne Global Fund Managers (Ireland) Limited (the "Management Company"). The Management Company is a private limited company, incorporated in Ireland on 16 August, 2013 under registration number 377914. The investment manager of Rubrics Global UCITS Funds Plc is Rubrics Asset Management (Ireland) Limited (the "Investment Manager"). The Investment Manager is a private company registered in Ireland (reference number:613956) and regulated by the Central Bank of Ireland in the conduct of financial services (reference number:C173854). Details about the extent of its authorisation and regulation is available on request. Rubrics Asset Management (UK) Limited is an appointed representative of Laven Advisors LLP, which is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Reference number: 447282). Laven Advisors LLP is not authorised to promote products to retail clients, all communications originating from either Laven Advisors LLP or Rubrics Asset Management (UK) Limited is therefore intended for professionals and eligible counterparties only. Data Source: © 2020 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. www.morningstar.co.uk.
For South African investors: In the Republic of South Africa this fund is registered with the Financial Sector Conduct Authority and may be distributed to members of the public. In addition to the other information and warnings in this document, the Financial Sector Conduct Authority of South Africa requires us to tell South African recipients of this document that collective investment schemes are generally medium to long-term investments, collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending and that a schedule of fees and charges and maximum commissions is available on request from the manager. Because foreign securities are included in the investments within this collective investment scheme, we are also required to disclose to you that there may be additional risks that arise because of events in different jurisdictions: these may include, but are not limited to potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks and potential limitations on the availability of market information.

Additional Information for Switzerland: The prospectus and the Key Investor Information Documents for Switzerland, the articles of association, the annual and semi-annual report in French, and further information can be obtained free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, tel.: + 41 22 7051178, fax: + 41 22 7051179, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva. The last share prices can be found on www.fundinfo.com. For the shares of the Funds distributed to non-qualified investors in and from Switzerland and for the shares of the Funds distributed to qualified investors in Switzerland, the place of performance is Geneva. Carne Global Fund Managers (Ireland Limited reserves the right to terminate the arrangements made for the marketing of this product in any EEA jurisdiction in accordance with the UCITS Directive.