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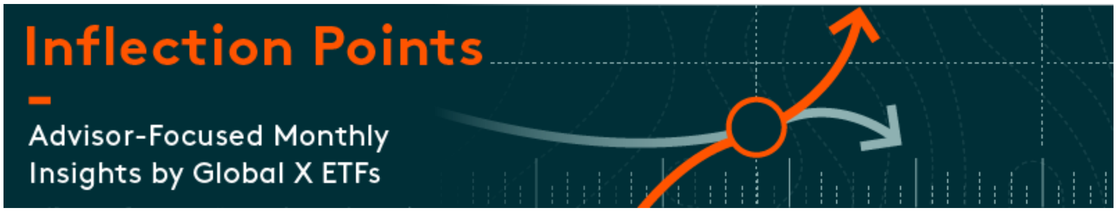
GLOBAL X ETFs – INFLECTION POINTS

Five Risks for 2023 Keeping Us Awake



Editor's Note: Inflection Points is a monthly series intended to explore the underlying trends, dynamics and opportunities shaping the thematic investing landscape. Click here to receive future updates via email.

A number of years ago, I began compiling an annual list of major geopolitical risks that could prove relevant to the market in the year ahead, with the operative word being "could." The piece is not a forecast of what's to come, but rather an exploration of issues that may not be fully priced into the market. Past lists touched on topics ranging from concurrent election cycles in western economies to public health risks from genetic engineering. I generate the list in consultation with colleagues, policymakers, investors, and academics. The related themes identified below are associated with each individual risk rather than intended as an outlook or strategy for 2023.

At the close of 2022, I am more optimistic than most for the year ahead. Major triggers of recession, beyond Federal Reserve (Fed) rate hikes alone, are not flashing red. The labor market remains strong with low unemployment rates and strong nominal wage gains that can continue to support consumer sentiment.[1] Leverage remains modest in the household sector while companies continue to maintain record cash balances.[2] Liquidity is getting tighter as rates rise, but financial conditions remain loose and are only moving toward neutral after several Fed hikes.[3] Growth can slow without the U.S. tipping into recession. Several risks could shake my optimism, and here are my top five for 2023.

Five Risks

- China's 2023 Strategy: Nationalism or Reopening
- Fed Sticks with 2% Inflation Target
- Contagion from Emerging Markets
- Addicted to Stimulus
- Russia Escalates the Conflict in Ukraine

China's 2023 Strategy: Nationalism or Reopening

China's policy decisions could result in two very different scenarios in the year ahead amid growing protests over the zero-Covid policy.[4] Softening of the zero-Covid policy that facilitates even a modest economic reopening would offer a tailwind for global and regional growth likely increasing investor appetite for risk assets like equities.[5] Should the government choose to maintain the current restrictive economic conditions, China's policies may turn increasingly nationalist, including applying pressure on Taiwan.[6] The closing events of the National Party Congress did little to reassure investors that a reopening would materialize in the near term, and Hong Kong shares sold off over 9%.[7]

When the U.S. and China met at the G20 meeting in Bali, Chinese leadership reiterated that Taiwan remained a critical policy consideration, while U.S. leadership indicated that their longstanding Taiwan policy remained in place.[8] The meeting was said to be cordial, but there were references to multiple areas of competition between the two nations.[9] Strained since 2016, U.S.-China relations show few signs of improving meaningfully, which may be driving a view within China that the current world trading system is no longer advantageous.[10] More hawkish policies that have potentially disruptive impacts on the economy and markets are possible.

Related themes: Cybersecurity, alternative energy, and robotics may well be the front lines of the next "arms race" amid chillier U.S.-China relations.

Fed Sticks with 2% Inflation Target

The Fed adopted the 2% inflation target back in 2012 after the Great Financial Crisis and decades of importing deflation from China. At the time, getting inflation to reach that level was an ordeal, and the target signaled that monetary policy would remain loose to bring inflation up.[11] However, there's nothing special about the 2% target, and pursuing a target with little rationale other than historical precedent could undermine a U.S. economy that might be perfectly capable of accepting 3% or even 4% inflation.[12]

Central banks can be slow in adjusting to changes in inflation expectations.[13] Fed officials reiterated that inflation was "transitory" for nine months before changing their messaging.[14] The November policy statement reiterated a commitment to the 2% inflation target. In attempting to drive price increases down to that level, a risk is that central banks hike too aggressively. Rate hikes are already impacting housing affordability, a major component of core inflation. Excluding housing, core inflation already shows signs of slowing, as are producer prices, but higher mortgage rates put upward pressure on inflation through housing and rental markets. With one-year ahead inflation expectations at 5.9%, aiming for 2% might lead to overly aggressive policy.[15]

Related themes: The old adage of "don't fight the Fed" means there are not many options among risk assets. Healthcare themes like aging population are one option. Cloud computing with a recurring revenue model is another.

Contagion from Emerging Markets

Emerging market countries suffered a hat trick of challenges since 2019.[16] Public health consequences associated with the spread of Covid-19 was the initial blow.[17] Economic pressures followed as governments incurred debt to provide support through fiscal stimulus.[18] The most recent impediment is the combination of the war in Ukraine and inflationary pressures making food and energy more expensive.[19] EM equities reflected these pressures and underperformed the MSCI ACWI since 2019.[20] The resilience of markets like Southeast Asia and China's potential reopening offer reasons for optimism, but challenges persist in a global economy likely to see slowing growth.

Risk of an EM crisis leading to contagion seems elevated after these successive events. Past crises like those in Mexico (1994), East and Southeast Asia (1997), and Russia (1998) triggered selloffs in global markets.[21] Much of the recent debt issuance to support EM economies wound up on local bank balance sheets, which is both good and bad.[22] Unlike prior crises, where debt was issued in foreign currency, debt held with banks is denominated in local currency. The bad news is that government borrowing now accounts for 17% of EM bank balance sheets amid record government indebtedness.[23] As a reference point, debt-to-GDP before the Asian Crisis in the four largest ASEAN countries rose from 100% to 167%.[24] Today, that number among the broader EM countries is 250%.[25]

Related themes: Less exposure to EM and more exposure to U.S. infrastructure could prove a resilient strategy. Commodity exposure in lithium & battery technology could also weather EM pressure given elevated demand from electrification.

Addicted to Fiscal Stimulus

After approximately $5 trillion of U.S. fiscal stimulus in just about two years, government spending is likely to level off going into 2023.[26] Governments around the world spent considerable sums during the pandemic, and removal of that support, at a time of higher rates and slowing growth, could be difficult for markets.[27] Shrinking public sector engagement in the economy would place more pressure on the private sector, especially the U.S. consumer.

The Covid-19 pandemic struck at an odd time for government spending. Concepts like universal basic income (UBI) and Modern Monetary Theory (MMT) were gaining popularity in U.S. policy circles, with MMT arguing that governments could borrow as much as they wanted, provided the debt was denominated in the home country currency.[28] The Covid-19 response anecdotally tested these theories and revealed potential shortcomings. Labor markets have been very tight since Covid stimulus was introduced, which is a concern associated with UBI.[29] Simultaneously, massive amounts of stimulus likely contributed to the current inflationary impetus. [30]

With the 2022 midterm elections in the U.S. delivering a divided government and global public sector borrowing stretched, markets will likely be forced to move forward with less government-offered liquidity.[31] The U.S. consumer may offer the best hope of muddling through as markets adjust to a more austere fiscal environment.

Related themes: Consumer spending on staples and low-cost activities could find support in this scenario with themes like the millennial consumer and gaming & esports playing key roles.

Russia Escalates the Conflict in Ukraine

The decision to employ nuclear weapons in Ukraine would be tragic. Loss of life could be considerable, and this would be the first time nuclear weapons were used since 1945. There have been almost 20 wars and countless military operations since then, but no major power has crossed the line and utilized nuclear weapons.[32]

The specter of Russia using nuclear weapons in Ukraine remains a possibility that could grow more acute in 2023. When Russia invaded Ukraine in February 2022, there was little talk about use of tactical nuclear weapons, but Ukraine’s ability to withstand and even push back Russia’s advance increases the likelihood that Russia’s leadership gambles.[33] With winter stasis likely to set in on the battlefield, Ukrainian forces appear well-positioned for major gains, including taking back Crimea, when the spring fighting season begins.[34]

The logic to using small-scale nuclear weapons is quite limited, particularly in urban settings.[35] Hopefully, Russia has done that calculation, as the implications of nuclear use would be far-reaching.[36] The U.S. and Europe would almost certainly have to take a more active role in the conflict, increasing exogenous market risk possibly driving funds out of risk assets and into government bonds.[37] Russia’s willingness to attack critical infrastructure and trading routes could mean further constraints on energy, food, and material exports.[38] International organizations and agreements would be tested. China has largely avoided commenting on Russia’s invasion, but leadership condemned use of nuclear weapons in the conflict during the recent G20 bilateral with the U.S., a sign that Beijing is also concerned.[39]

Related themes: Further pressure on exports could bolster demand for alternative energy areas like cleantech, wind, solar, and hydrogen as means of countering disruption in energy markets. Agriculture technology may attract attention amid further tightening of global food supplies.

Conclusion

The five risks highlighted in this report are just a few of the exogenous and geopolitical events that could impact markets in 2023. For example, political polarization in Western democracies persists. Continued meltdown in crypto and potential regulation could put pressure on liquidity. North Korea and Iran maintain nuclear weapons programs outside of accepted international conventions. Politics in South America and the Middle East are often challenging. Fossil fuel supplies or pricing can turn volatile. Cybersecurity remains a weak point for many public and private institutions. A follow-on pandemic could upend public health. Currency markets and default rates will remain an area of concern. As always, investors will have an array of variables beyond economic and market activity to consider at the start of 2023.

Footnotes

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