Review of 2022: The end of rock-bottom interest rates

As in the two previous years, 2022 was hammered by new shocks. Excluding China, the Covid-19 pandemic was followed by the equally traumatic Ukraine war, a conflict which had economic and financial consequences across the globe, starting with inflation. As such, we are tempted to use the pandemic vocabulary to describe rising prices which have occurred in waves resulted from the pandemic.

The first inflation wave at the beginning of 2022 essentially resulted supply and demand imbalances in commodities and maritime transport, a consequence of Covid-19. The second wave was the result of Russia's invasion of Ukraine and affected energy and agricultural commodities. In Europe, soaring gas and electricity prices undermined industry.

However, shortages from the sudden end to gas deliveries and electricity outages have so far been cushioned thanks to reduced consumption, moves to diversify supplies (and especially LNG) and relatively mild temperatures in the autumn months.

The third inflationary wave hit services, a particularly worrying area for central banks as it is a harbinger of higher prices stoking wage inflation. This wave gathered strength throughout the year and became a key central bank indicator to gauge whether their polices were working.

Now there is a risk of a fourth wave in the form of a wage-price spiral. The situation is for the moment under control but accelerating wage rises mean the risk should be taken seriously.

All in all, the return of inflation upended more than 10 years of monetary easing and marked the end of rock bottom interest rates. What's more, interest rates have risen faster than ever before. The Fed has hiked rates by 425bp since the middle of March, including four 75bp hikes in a row. It has also started to shrink its balance sheet by not reinvesting the proceeds from a certain monthly amount of bond redemptions. The ECB only started moving in July but has now raised its three benchmark rates by 250bp. Excluding China, the whole world has started to tighten. Even the Bank of Japan has turned more flexible over its *Yield Curve Control*. On December 20th, it decided to allow 10-year government bond yields to fluctuate between minus 0.5% and +0.5% (versus minus 0.25 and +0.25% before).

This difficult environment quite logically affected economic growth, reducing household spending as purchasing power decreased and hitting investment with higher borrowing costs. Growth forecasts have been repeatedly downgraded. Last January, the IMF was expecting global growth of 4.4% in volume for 2022 but in October cut its forecast to 3.2%. It now sees US growth up 1.6% (down from 4%), 3.1% in the eurozone (3.9%), 1.7% in Japan (3.3%) and 3.2% in China (4.8%)

On another note, the toxic cocktail that hit the global economy in 2022 has exposed areas that could prove vulnerable in the future. US inflation is being stoked by persistent labour market supply and demand imbalances, mainly because the participation rate for people over 55 years old has declined sharply since the pandemic. In the eurozone, counter-cyclical budgetary measures to help households are undermining the ECB's monetary tightening efforts while higher rates could end up making government debt levels unsustainable. The UK is struggling to recover from Brexit's economic fallout. China is paying a heavy price for its zero-Covid policy and its abrupt reopening is stoking fears of another global inflationary wave.

From a purely financial point of view, higher interest rates and quantitative tightening to fight inflation quite logically caused a drop in financial asset values in 2022.

- The rise in 10-year government bond yields from zero to 3.87% in the US, 2.57% in Germany and 3.12% (as of December 30) resulted in significant losses. The ICE-BOAML Euro Government Bonds All Maturities index ended the year almost 17% lower. Corporate bond spreads ended 2022 at 159bp, up from 78bp a year earlier, or back to Covid crisis levels in the spring of 2020. The shift obviously hit high yield issuance more severely. New bond issuance remained buoyant but the number of deals declined. Companies started turning to bank loans for funding.

The most significant development was yield curve inversion in the US with 2-year yields at 4.43% on December 30 and 10-year yields at 3.87%. In the eurozone, the yield curve flattened before inverting at the end of the year. Yields on the 10-year Bund were at 2.57%, or lower than 2-year yields (2.76%) as investors began to factor in a recession in 2023 and central banks warned that rates needed to continue rising to beat persistent inflation, especially in services. After all, real interest rates are still negative.

The Euro short-term rate (€STER) recovered to zero during the year, up from minus 0.51% in 2021.

- Equity markets tumbled due to rising rates but company earnings remained robust. S&P 500 third-quarter earnings rose 4.4% over a year while STOXX 600 earnings jumped 33% according to Refinitiv, thanks to price rises. Market multiples fell as a result. In today's very rare environment where bonds and equities have been falling in tandem, long-term savings like pension funds and retirement schemes failed to perform. A portfolio comprising 60% bonds and 40% equities (a typical breakdown for pension funds throughout the world) lost 15% on average in 2022 (source: Bank of America). The Dow Jones lost 8.8%, the S&P500 19.4%, and the Nasdaq plunged 33.1%. In Europe, the Stoxx600 declined by 12.9%, the CAC 40 by 9.5% while in Asia, the Nikkei 225 fell 9.4%, and the Hang Seng 15.5%. In a major sector rotation, investors dumped tech stocks, a love affair since 2020 but now viewed as expensive due to higher rates. Instead, they shifted into oil and commodity stocks on higher crude prices, abundant cash flow and balance sheet restructuring. Healthcare, insurance and telecoms also proved resilient.

The drop in asset prices was compounded at the end of the year by the first signs of a fall in property prices due to tighter lending conditions on bank loans.

Asset returns varied in line with currency market moves. The US dollar dominated trading, rising on rapid Fed hikes as investors looked for a safe haven after the Ukraine war started. The yen was particularly weak. One dollar was worth 131 yen (+13.94%) on December 31. This was due to the Bank of Japan keeping its benchmark rate at minus 0.1%, a stance it justified by arguing that inflation was due to external factors like energy so monetary policy changes would be of no help. The euro lost 6% against the dollar, dragged down by geopolitical risk (Ukraine) and the ECB's late move to raise rates. But it gained 5.23% against sterling due to chronic political instability in the ruling Conservative government. Sterling also tanked 11% against the dollar. Emerging country currencies all lost ground against the dollar which was trading at RMB 6.90 on December 31 due to Beijing's poor handling of the zero-Covid policy. The ruble was undermined by European and US sanctions following Russia's invasion of Ukraine.

Last year, the financial world flipped from a period of zero and even negative interest rates, during which central banks were haunted by the spectre of deflation, to positive interest rates as central banks tried to fight galloping inflation. **Returns on savings have returned to positive territory, good news for creditors and bad luck for borrowers even if real interest rates are still very negative.**

One thing is clear. **The double whammy of inflation and war,** plus the latent global warming crisis and the loss of biodiversity, **have added a little more uncertainty for asset managers.**

NAV OF THE FUNDS

			Cumulated Performances							
NAV Date	UCITS	NAV	% 1 Week	%1 Month	%3 Months	%YTD	%1 Year	%2 Years	%3 Years	%5 Years
30/12/2022	HUGAU OBLI 1-3 I	1 369,18	0,05	0,28	1,88	**-3,42**	- **3,42**	- **1,23**	- **1,74**	- **2,26**
30/12/2022	HUGAU MONETERME I	114 955,58	0,034	0,181	0,361	**0,031**	- **0,21**	- **0,30**	- **0,49**	- **0,52**

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