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# The Watchlist 2023

What's in store for financial markets in 2023?

# Foreword

The 2020s have seen a remarkable amount of change and disruption to financial markets. Whilst 2023 may not provide the kind of shocks we witnessed with the onset of the Covid-19 pandemic or the Russian invasion of Ukraine, it would be naïve to rule anything out. As the last few years have shown us; from political earthquakes like Brexit and Donald Trump; from the rise of cryptocurrencies to the end of cheap money; from pandemic to war; the financial markets are at the mercy, and are the reflection, of world events everywhere.

In the last year, monetary phenomena have been at the core of the change and disruption. Inflation has risen to 40-year highs in developed economies, forcing central banks to tighten financial conditions aggressively. One of the major questions for 2023 is whether they have done enough to rein in the inflation genie or still need to do more. This is perhaps the single most crucial test facing financial markets in the year ahead.

We await to see what happens in 2023 with interest. For the first time in many years investors cannot bank on central banks coming to the rescue. In this paper we attempt to outline some of the key themes, trends and tail risks for markets. As we saw with the pandemic in 2020 and the Russian invasion of Ukraine in 2022, year-ahead calls can quickly become obsolete. Some of these are bold calls, some reflect consensus expectations, and some may never happen; no plan survives first contact with the enemy. As always, we welcome your feedback and input.

Neil Wilson

**Neil Wilson**
Chief Market Analyst

# Contents

# Introduction

What's in store for financial markets in 2023? Persistently high inflation, tightening financial conditions, Russia's invasion of Ukraine, and the COVID-19 pandemic still rumbling on in China are all factors that made 2022 such a unique year and these will continue to be in play next year. Stock markets have endured a turbulent 2022 as central banks began aggressively tightening monetary policy, whilst a resurgent US dollar buoyed by rising US Treasury yields weighed on risk appetite in general. Big tech got found wanting, and speculative tech got found out. The tide went out of the crypto market, too, revealing those who, in the words of Warren Buffet, had been swimming naked.

The war in Ukraine led to a surge in commodity prices, further stoking the inflation that too-easy monetary and fiscal policy had sparked. Perhaps the most salient trend in 2022 was the emergence not just of inflation but of a self-sustaining inflationary dynamic that central banks were unable to control. This remains the big fight of 2023.

# Global macro: Inflation and central banks

More of the same? Global growth is forecast to slow to 2.7 percent in 2023, the weakest growth profile since 2001 except for the global financial crisis and the worst phase of the COVID-19 pandemic, says the IMF. Global inflation is forecast to decline from 8.8 percent in 2022 to 6.5 percent in 2023.

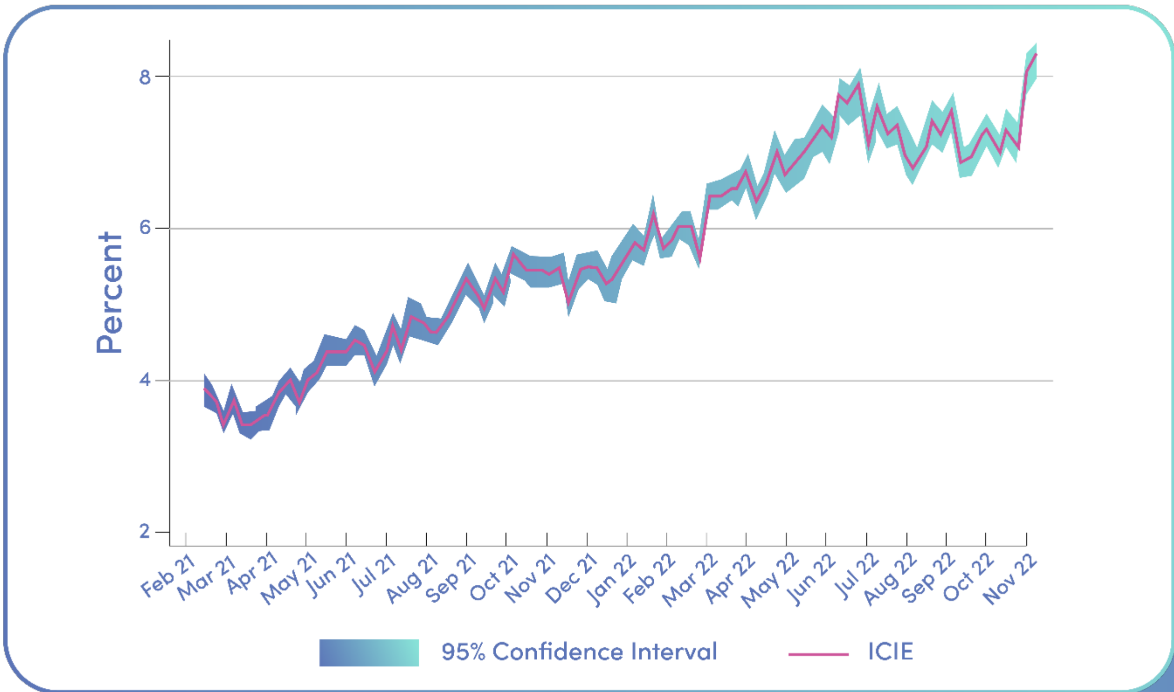
Whilst the world can avoid a hard landing recession, it seems likely that growth will all but stagnate and inflation will not die quietly. Central banks' reaction functions to these trends will diverge and this could be the source of ongoing volatility for global indices and FX in particular.

Macro has a habit of messing with consensus expectations, however. Just as we all assume inflation is unhinged and recession a certainty, what if it all tops out and the economy reaccelerates? There is a chance that this happens, but this would result in more inflation, even tighter Fed policy and further downside for the stock market. This, in short, highlights the predicament the economy is in; the result of allowing the inflation genie out of the bottle.

Uncertainty is the watchword for next year as competing forces play out on the global economic stage.

## Fed hikes further and for longer as inflation persists

Inflation will prove far stickier than many believe and the Fed far tougher.




*Indirect Consumer Inflation Expectations are soaring (source Cleveland Fed)*

## The problem facing the Fed and other central banks is that inflation is taking on a momentum of its own.

We have seen a paradigm shift in inflationary dynamics in which it becomes self-sustaining. Triggers such as the Ukraine war and longer-term causes like the increase in the money supply during Covid are no longer requisites for it to continue. As the Bank for International Settlements noted in a report earlier this year, we have reached "a tipping point, beyond which an inflationary psychology spreads and becomes entrenched". Or as German economist Karl Otto Pohl put it, inflation is like toothpaste; once it's out, you can hardly get it back in again. The fear is that monetary policy alone cannot tame this self-sustaining inflationary environment. Even Christine Lagarde, the head of the European Central Bank, admits that the world "will not return to the low-inflation environment" of before the pandemic.

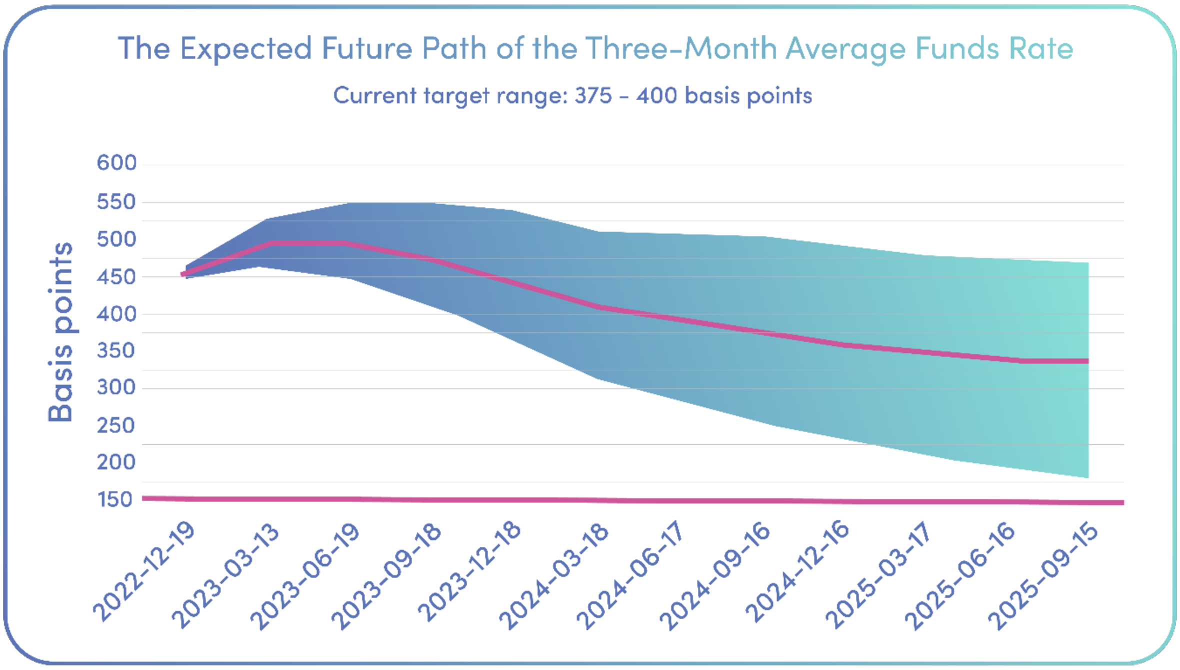
Jay Powell has been burnishing his Paul Volcker credentials and doesn't want to fail. Powell has used the phrase "keep at it" - from the title of Volcker's 2018 autobiography – several times in recent months, and this signals where the Fed is headed.

Markets are hooked on the idea of a pause or a pivot and when that might be. This is the wrong way to look at it. As Fed governor Christopher Waller said: "Quit paying attention to the pace and start paying attention to where the endpoint is going to be. Until we get inflation down, that endpoint is still a ways out there."

The Federal Reserve will not find that reaching 5% or so in the Fed funds rates will bring inflation to target quickly, forcing them to persist with more hikes for longer, whilst also pivoting to other means of taming inflation (see below). Markets currently price in the Fed peaking somewhere around 5% in February, holding it there for some months and then cuts towards the end of 2023 – this will need to change to reflect the hawkishness of the Fed and the ongoing stickiness of inflation. October's softer-than-expected CPI reading fuelled a lot of market chatter that we'd hit peak inflation; however, a peak is not the same as a plateau. A certain amount of disinflation is likely to develop in 2023 but the absolute level of inflation will remain elevated. The risk to the Fed going beyond 5% or so in the Fed funds rate would be a move to accept permanently higher inflation (3-5%) rather than strictly adhere to the 2% level. To a degree, average inflation targeting adopted in 2020 already allows for this.

Whilst Jay Powell has acknowledged that the terminal rate will likely be beyond 5%, we think the Fed and other central banks are underestimating just how much they will need to do to bring inflation back to target. This does not mean that each and every central bank will have the same reaction function – some like the Fed are in a relatively strong position to raise rates further, whilst the UK does not have that luxury. Even a recession in 2023, which seems likely, is not going to be enough to stop the Fed. More on that below.

Whilst this is a headwind for equity markets – stagflation tends to lead to bear market conditions – it will not prevent market rallies on hopes that the Fed is finally done hiking. Higher for longer rates ought to continue to support a stronger USD (though perhaps not scaling the highs of 2022), weaker gold, bonds and equities.




*Markets still think the Fed cuts next summer (source Atlanta Fed)*

## Treasury liquidity event

*"For all the talk of crashing the economy and breaking the financial markets. It hasn't done that." Fed governor Christopher Waller.*

Not yet anyway.

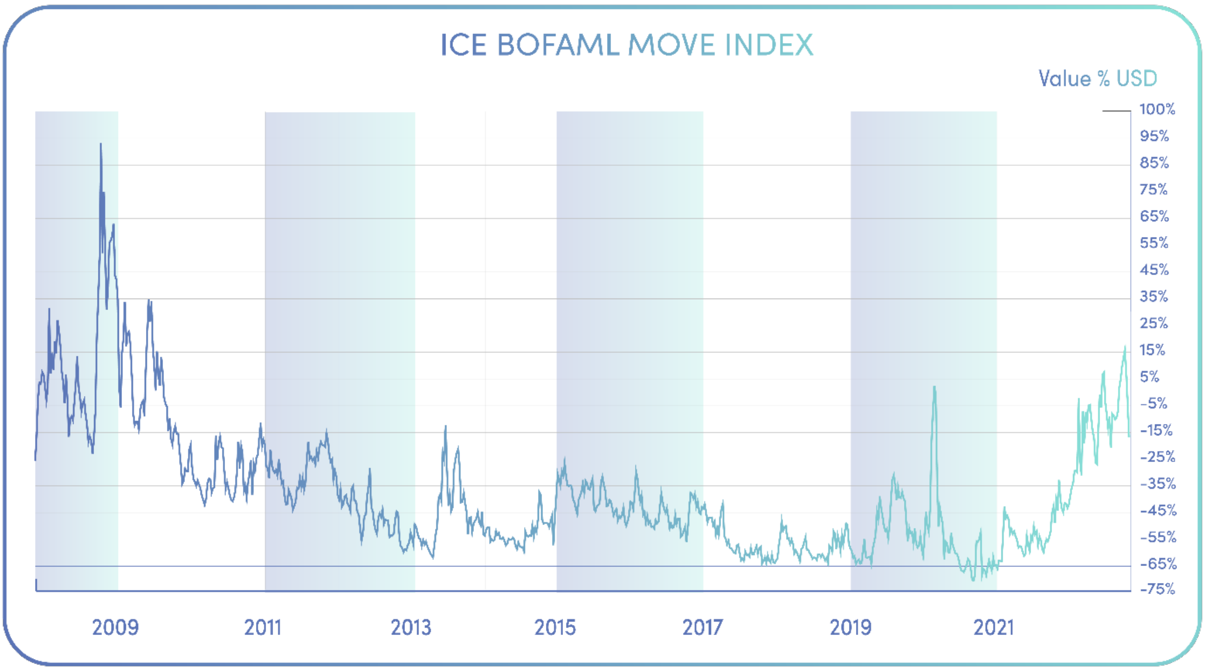
**A liquidity event such as that seen in March 2020 is extremely possible.**

The Fed's quantitative tightening is making low liquidity and high volatility in the $20-trillion US Treasury debt market worse. It has moved from being the largest marginal buyer – around 40% of the market – to a net seller. As the Fed enters 2023 with additional rate hikes on the table, it may be forced into halting the sale of Treasuries and mortgage-backed securities (MBS) in order to shore up financial markets and prevent instability in the crucial Treasury and overnight repo markets. Certainly, liquidity problems have been brewing in the Treasury market for some time, but there is a risk that the more QT is done the more acute these might become.

The Federal Reserve raised alarm bells last year, warning in its Financial Stability Report of the systemic risks posed by declining liquidity. It noted that market liquidity had declined since late 2021 in the markets for recently-issued US cash Treasury securities and for equity index futures, and that while the recent deterioration had not been as extreme as in some past episodes, "the risk of a sudden significant deterioration appears higher than normal".

However, the Fed will be reluctant to stop QT, since a large chunk of the $5tn pandemic QE is responsible for today's inflation. You must accept, therefore, that shrinking the balance sheet is an important tool alongside rate hikes to curb inflation.

This goes to the heart of the dilemma facing the Fed next year. You press on with QT until something breaks, or you back off and inflation doesn't go away.

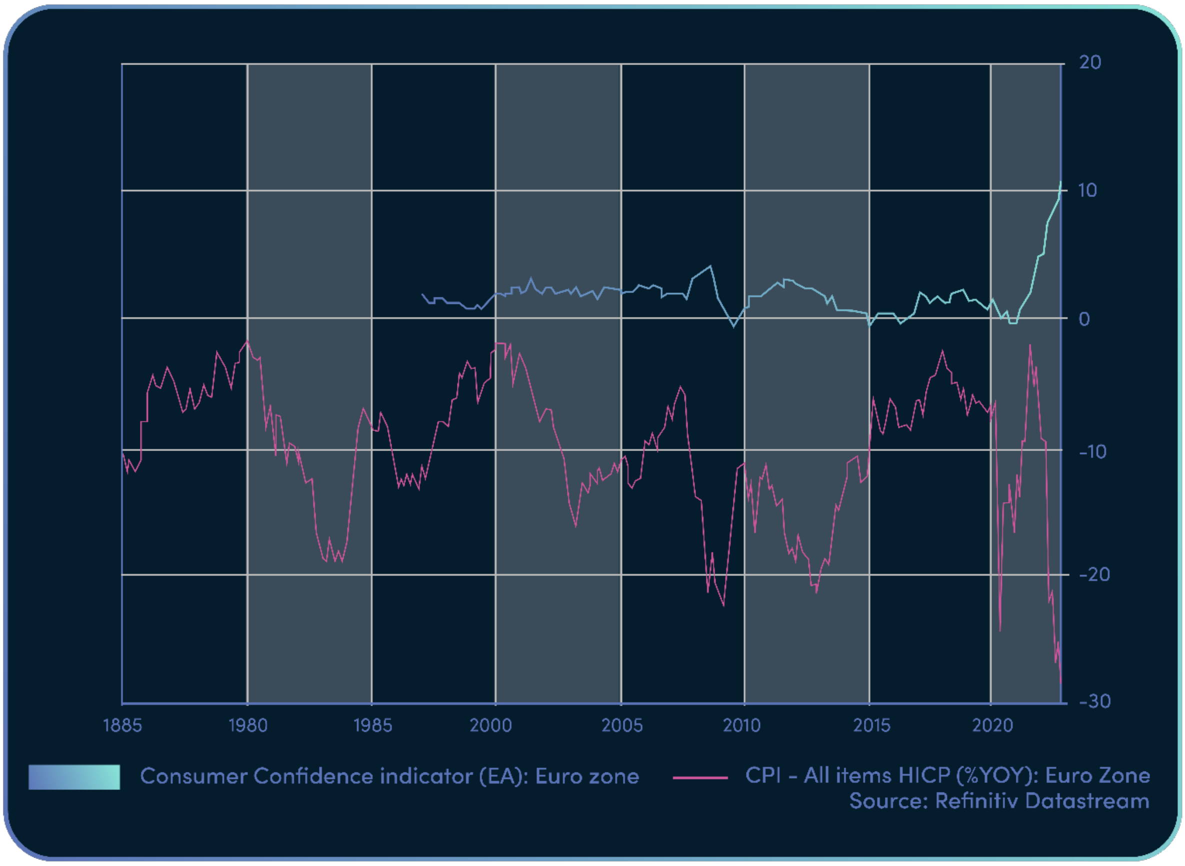



*The ICE BofA MOVE Index, a gauge of expected volatility in US Treasuries, has risen to levels last seen during the Great Financial Crisis. (source: Refinitiv)*

## Slow moving recession, but not as we know it

Stagflation: The combination of ongoing uncertainty around interest rate policy, high inflation, and continued weakness in household and business confidence is likely to push the world into a synchronised recession. But as Christine Lagarde pointed out, recession won't be enough to tame inflation. This points to continued stagflation conditions with higher-for-longer inflation coupled with lower growth rates. Echoing the IMF, we think things will get worse before they get better.

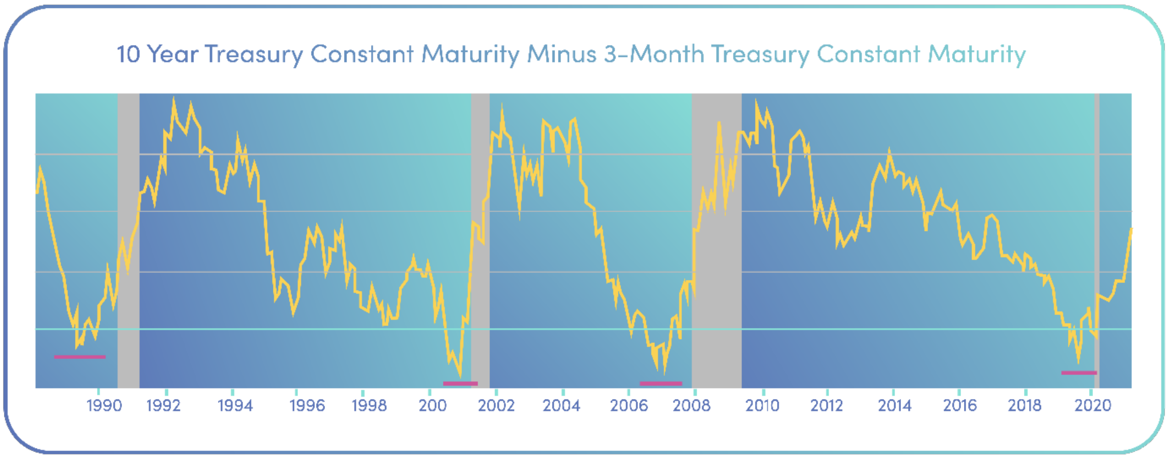
The Eurozone is already in a recession. Consumer confidence might pick up towards the latter half of the year but for now the picture remains quite bleak as we head into winter. With inflation at 10% and still not peaking, and consumer confidence at multi-decade lows, it's hard to see an easy way out. And whilst there is some better wage growth, all in all falling real incomes will weigh on aggregate demand. Even with disinflation in 2023, absolute price levels remain high and the consumer still feels less well off.



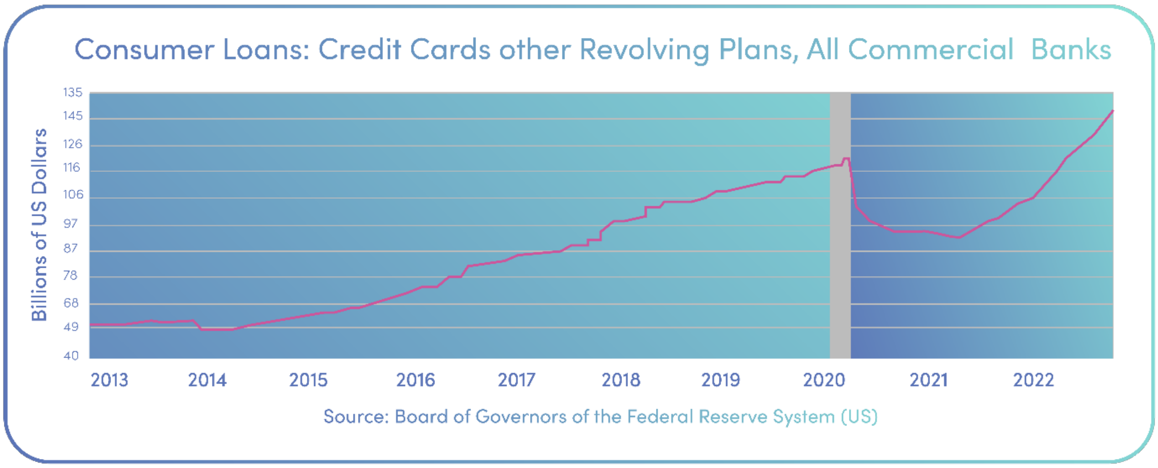

*Confidence and inflation are intertwined (source: Refinitiv)*

The US is heading for recession in real terms, though this is a closer call to make. The inversion of the 10yr Treasury yield and 3-month is a pretty good predictor of a recession, albeit a lagging indicator. In October it inverted for the first time since 2020. The last eight recessions in the US were all predicted by this 3mo/10yr inversion. Survey data point to persistent pessimism among businesses and consumers that can become self-fulfilling.

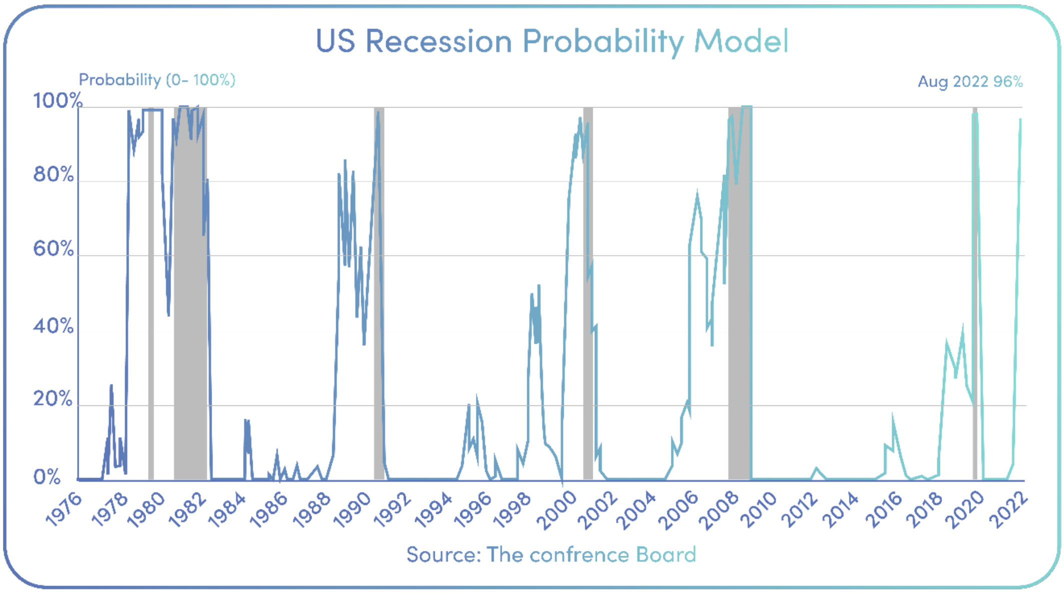
There are 11m jobs open in the US. This recession won't look like the last. Nominal growth continues. The labour market holds up but slow to negative real growth persists. It will be a stagflation period – recession but not as we know it. Labour is so tight (excess labour demand vs supply), begetting further inflation, leaving the Fed unable to fall back on its old habit of cutting rates to limit the recession.




*A pretty good indicator of recession (source: St Louis Fed)*




*After significant household deleveraging during the pandemic, US consumers are loading up on debt again. (source: St Louis Fed)*




*Conference Board modelling indicates a recession is coming. (source: Conference Board)*

## ECB suffers QT failure to launch

Long-term inflation expectations in the Eurozone will peak in the first half of 2023 just above current levels before easing back below 2%. This will give ECB members confidence to pause rate hikes and embark on the process of reducing the central bank's balance sheet. But quantitative tightening into a weak economy and high inflation dynamics is not going to be straightforward. Expectations for QT will see peripheral spreads widen despite tools designed to mitigate the damage. Moreover, higher rates will mean higher borrowing costs; countries like Italy just won't be able to wear it. Meanwhile an ongoing energy crisis will continue to eat away at industrial confidence and output. The ECB may talk about QT a lot next year but might end up cutting rates before it has the chance to test the market with bond sales.

## Blackouts

But not in Europe...probably. Whilst the EU endures a prolonged energy shortage/crisis, it's emerging markets that are suffering as richer nations suck gas away from the rest of the world. Pakistan is already enduring blackouts throughout the day; whilst Europe is building LNG capacity as it talks up renewable energy and nuclear. The UK has also been striking deals with the US and Qatar to ensure supplies of LNG. South Africa has suffered more than a 100 days of power cuts this year and is likely to remain susceptible to regular blackouts in 2023.

But Europe may be complacent about its energy security still. Although the situation heading into the winter is not as bad as feared - storage is full after a mild autumn – Europe can no longer rely on Russia to act as the marginal supplier of last resort. This creates ongoing risks, but investment in LNG terminals and capacity will help foster a single global gas market, which could result in lower levels of volatility in the US Henry Hubbard contract.

Crucially, what we have seen in Europe in recent months is nothing short of remarkable. The reduction in gas demand whilst maintaining output is a testament to the capitalist economic system responding to price signals and adjusting demand and supply accordingly.

## Dollar intervention

Whilst Japan has been blowing its FX reserves to shore up the collapsing yen, there has not been much chatter about coordinated intervention in the FX markets this year for good reason. Despite the fact that the kind of disorderly FX moves like we have seen with the dollar in 2022 is known to negatively impact economic and financial stability, the US has not had a motive to act. For starters, to weaken the USD the Fed would have to pause hikes, and it's certainly been in no mood to do that. But as a persistently higher US dollar creates worsening financial stability risks and imbalances, we could see the G7/G20 coordinate intervention to weaken the US dollar. This could form the basis on which CBs pivot away from bluntly raising rates with the diminishing marginal returns this policy has to focus on currency stabilisation as a primary inflationary transmission mechanism.

Won't weakening the dollar make inflation worse in the US? Not really, as many goods are priced in USD and the economy is more domestically focussed and less reliant on foreign trade than many others. This makes intervention possible if the RoW is hurting enough, and financial stability risks are bubbling up significantly. The Fed and the Treasury may get to the point next year when weakening the dollar seems like the better option. However, if China reopens quickly this would be positive for risk, lower the USD and arguably might make coordinated intervention unnecessary.

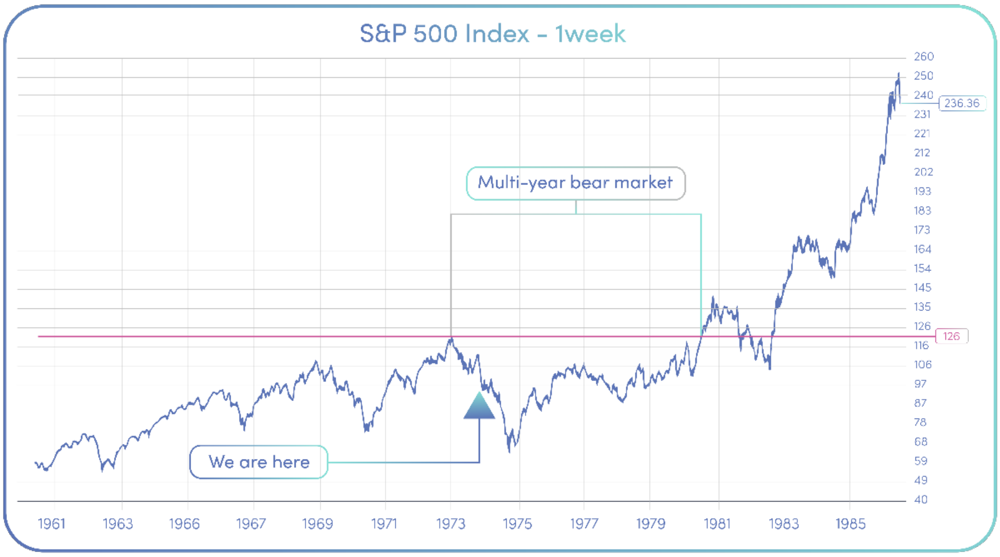
## Earnings recession breaks S&P in final leg lower

**Whilst rate uncertainty will persist and drag on multiples for stocks, the final leg lower for the bear market will come from earnings.**

Even without a recession S&P 500 earnings may decline by around 10% next year, implying a price of 3,200 for the index. And it could be worse than that. Investors have not really priced in a significant drop in earnings next year. If earnings declined by 20% - as they tend to do during a recession –it would drag S&P 500 EPS down to $176. And if you were to see rising interest rates push multiples to 15x earnings – as has happened three times recently, the most recent during the pandemic – then we could see the S&P 500 test 2,600. Multiples that low are rare but a recession + rising rates + inflation present the kind of conditions that could lead the market there. After a push higher in Q4 '22, stocks are set for another choppy year.

A low of 2,600 implies a roughly 45-50% peak-to-trough drawdown which is analogous to the 73/74 bear market. Ultimately this is the same playbook with asset prices requiring to reset lower as the Fed is obliged to tighten until it breaks either the economy or the market.

If the 70s analogy works, then we are about here (see chart) – a major flush lower to come before a decade of sideways price action and poor returns. The bear thesis is that bad inflation > stagflation flush > recession and deflationary bear market. In the words of the great Stan Druckenmiller, all those factors that cause a bull market are not only stopping, but are reversing. 2022 saw the early-stage secular leadership shift from deflation assets like growth, large cap tech and speculative tech stocks to inflation assets like commodities, small cap value, European banks.




*We are here (source: TradingView)*

# Covid-19

## China ends zero Covid policy

China has made tentative steps to reduce some of the restrictions still in place. Recent headlines appear to mark the start of a period of preparation for reopening that will take several months. 2023 will likely see this process move forward ultimately to the end of the zero Covid policy by the second half of the year. This will require the necessary medical steps to be taken since case fatality rates remain quite high among the unvaccinated based on Hong Kong data. For instance, elderly vaccination rates remain low and will need to improve. Easier access to Covid medicine will also need to improve.

If China reopening is positive for commodities, it might well push up inflation. Domestic demand would also improve. On the other hand, easing of supply chain 'woes' might be a positive for global inflation trends. On balance, higher commodity prices would tend to be problematic as it might reignite goods inflation just as it has come down. Based on some of the aggressive moves higher for Chinese and Hong Kong stocks seen in Q4 2022 when rumours circulated about a reopening, this may well prove to be a buy-the-rumour, sell-the-fact type situation for equity markets.

Critically, a full China reopening could help stave off a global recession by boosting output and demand. However, it could reinforce inflationary dynamics and force the Fed to raise rates more than expected.

**There is a high degree of uncertainty around the extent and timing of reopening and the impact on financial markets.**

And longer term, there are questions over China's position as the driver of global growth. India's population is set to overtake China in 2023 as China's starts to decline. There are also serious problems in the Chinese economy that cannot be papered over for much longer.

# The Bull Case?

A lot of what we've talked about here so far is pretty downbeat. But China reopening could be bullish for equity markets. The easing supply chain constraints and boost to global demand would support the global economy. This could allow markets to overlook rising interest rates. The other side of this would require inflationary pressures to ease much quicker than thought. This could happen due to easing of supply chain constraints (China), peak in shelter inflation (Fed) and slower wage growth.

# UK: weakness prolonged

The outlook for the UK economy is rather bleak. The Bank of England predicts the longest recession since the 1930s. A cost-of-living crisis, rising mortgage bills and weak productivity growth, combined with fiscal restraint (less spending) will combine to make 2023 a year to forget. Headwinds aplenty with global growth slowing, confidence deteriorating and stubbornly high inflation squeezing disposable incomes further. The only relief might be for mortgages as the Bank of England eases policy, but this will be a double-edged sword.

## Housing market slumps

Dramatically rising interest rates. All time high in-work poverty rates. A looming recession. Coupled with house growth rate volatility, it is easy to draw historical parallels and predict a housing market crash in 2023. Is this a prediction based more in fact? Or fear? The housing market is certainly due a correction, but it is unlikely to crash in the same way we saw in 2008 - where house prices imploded as low as 50% in some areas.

A lot has already happened. MSCI's UK Quarterly Property Index declined to its worst quarter since 2009 in the third quarter of 2022. And though there might be dark clouds on the mortgage horizon, this is not the GFC. A 5-10% fall in average prices would more of a prang than a crash, albeit deepening the damage to the country's 'wealth effect' and further damaging consumer confidence. Mortgage rates probably won't go as high as feared and may start to fall next year.
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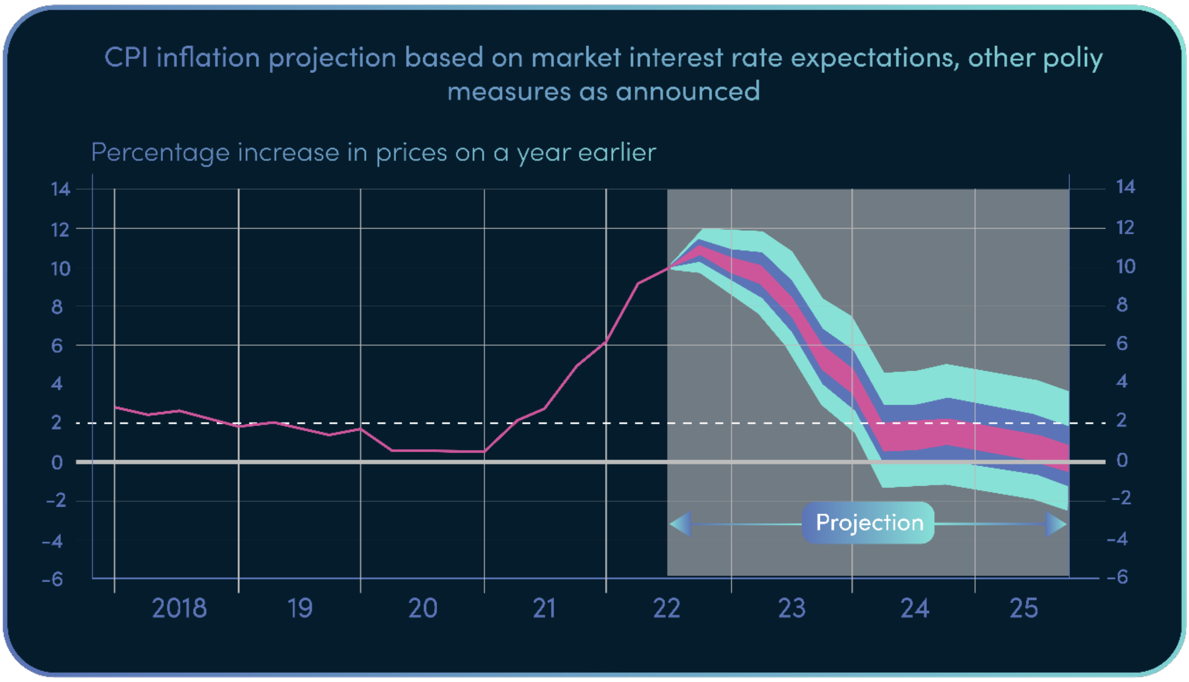
Supply remains incredibly restricted, particularly as the Conservative government reins in its horns to defend its heartlands from the Liberal Democrats; no tearing up of the green belt. Housebuilders, faced with a straitened economic backdrop and falling real incomes, have little motivation to build more. With high material and labour costs, why not sit on the land banks and wait for higher prices again? And demand, despite higher mortgage rates, energy bills and inflation at 10%, remains relatively high with large numbers of people still energetically trying to get on the housing ladder. In a free market, high prices, which we have had, tend to come down to where the demand is. That level is probably not too far off. The real danger for the market is a longer-term slow grind lower as real incomes fall. However, the Bank of England might have some good news in store for homebuyers next year

## Bank of England cuts rates, makes inflation worse

The Bank of England has rarely failed to burnish its dovish credentials throughout the recent hiking cycle. Again and again the BoE has tried to tame rate hike expectations and stress that the risk to growth – and hit to living standards - was a major factor in tempering rate hikes. Paradoxically, the biggest threat to the economy, cited by the Bank itself, was inflation. It remains so, and the Bank will continue to fall short of this Catch-22 situation. Even when it raised rates by 75bps in November, two members of the Monetary Policy Committee dissented, with one even calling for just 25bps in hikes. And the governor, Andrew Bailey, was at pains to suggest that the market had priced in too many interest rate hikes. An acutely British problem faces the Bank – raise rates enough to tamp down on inflation and you crash the property market.

Next year the pressure on the Bank of England to cut interest rates will become unstoppable as the country enters a prolonged recession and the worst cost-of-living crunch in memory. But it will be a policy mistake that sets off further currency instability and worsen inflation.




Bank of England inflation projections

# Politics

## Donald Trump stumbles, Republicans find new leader

Donald Trump announced his plans to run for the White House in 2024. However, his star shines less brightly today than it used to. Midterm elections underlined his toxicity to many voters, energising the younger Democrat vote. And there is a new poster boy for the Republican Party in Ron DeSantis, whose resounding victory in Florida puts him in a position to take on the former President. There will be blood, but by the end of 2023 there will be a clear favourite for the GOP nomination.

## Un-government

The health impact of the pandemic might be fading but it is casting a long shadow on the political world. The electorate was already fed up with the establishment in the wake of the financial crisis, feeling that they had to pay the price for greed and stupidity of "the 1%". They turned to the open embrace of anti-establishment figures leading to political results unexpected by the elite. Donald Trump's smartest move was to portray himself as outside of the elite, an insurgent within the established Republican Party. Nigel Farage and Brexit had the same impact, as did the 5 Star Movement in Italy and Emmanuel Macron in France, who even managed to set up a whole new party to sell himself to the country.

But then along came an emergency of such epic global proportions that only the establishment could respond. A red bus emblazoned with £350m couldn't get a vaccine into your arm. And so the electorate split. Some of those who had railed against the establishment decided they preferred its warm embrace after all, particularly when it paid them not to go to work. Others were horrified by the further encroachment of the State into their lives and repudiated it even further. This means that along with a left-right split over the economy, there is a divide between authoritarianism and libertarianism. It is far harder to win over an electorate shattered into so many pieces. Far from trying to please most of the people most of the time, leaders find themselves unable to please anyone, any of the time.

This makes it extremely difficult to govern. Britain's embarrassing record of three Prime Ministers and four Chancellors in just three months is testament to that.

But it's not just a problem in the UK. Germany has its first ever three-party coalition which would be struggling to find a consensus even without the thorny issue of a war on its front doorstep. The Socialists, the Green Party and the pro-business pro-balanced budget FDP are trying to find common ground over existential issues such as nuclear power. Italy's new right-wing coalition barely got out of the traps before Berlusconi denounced its new Prime Minister, Georgia Meloni, as "patronizing, bossy, arrogant and offensive". France opted for Macron as President but then delivered gains in Parliament for both the far-Right and the far-Left, leaving him flailing in the middle. His Prime Minister narrowly avoided losing a confidence vote at the end of October by just 50 votes after right-wing Le Pen's MPs joined up with Melenchon's left-wing bloc. Governments are surviving, but they're not governing.

# Fiscal Impotence

This creates a very difficult issue when it comes to fiscal policy. Taxation and Spending are by their nature determined by the values of the government: should schools get more money than hospitals? Should the wealthy pay more tax than the middle class? It's hard enough for one party to agree on a policy platform at the best of times but after such economic shocks it's even tougher.

Ironically the UK went into the economic shock with the strongest government, at least if you look at the numbers. Rishi Sunak holds a working majority of 69 MPs, something Biden, Scholz and Macron would usually look at with envy as they each try to hold together far more fractious legislative mathematics. But then Sunak's predecessor attempted a big fiscal stimulus and shot its legislative advantage in the foot.

In truth the Conservative Party had been sabotaging itself for months before then, with Boris Johnson unable to wield the majority despite winning it in 2019. The cracks that caused party discipline to break down completely will not be easily mended, even with a change of PM. At a minimum Rishi Sunak needs to get the Party back to polling around 30%, where it was under Boris, bringing down the gap with the Labour Party to 10 pts from the massive 30-pt gap that ensued after the Gilt market debacle. It will be difficult for him to unite his party and the country, while maintaining credibility with financial markets, leaving him fiscally hamstrung.

It's no better for Eurozone governments who must also face the constraints imposed by monetary and fiscal union. The Next Generation EU Recovery Fund was announced to great fanfare during the depths of the pandemic as it was the first time the bloc created its own fiscal support rather than leaving it to member states. But the implementation of such a new tool has been difficult with disbursements in some countries only starting to take place this year.

Joe Biden may have a kind of working majority of sorts in the Senate, but even then, he faces a hostile Republican majority in the House of Representatives. There will be little policy enacted from the US now that the knives are out in the run up to the big 2024 election.

The fiscal levers are therefore useless just as growth turns lower across the western world. But fiscal levers not being pulled is probably a good thing for taming inflation.

# Credibility doom loop

This is quite the turnaround from the pandemic period where "Whatever It Takes" graduated from the mouth of an esoteric eurozone central banker to the mantra from governments everywhere. They threw the kitchen sink at the global lockdowns with a huge monetary and fiscal splurge.

Now that Putin's invasion of Ukraine has created an economic war, squeezing the supply side and driving prices higher, the phrase has reversed 180 degrees to "Whatever It Takes To Stop Inflation". That means the exact opposite response from policymakers as central banks fall over themselves to hike rates and governments try to balance energy price caps with prudent fiscal goals.

If anyone had wanted to attempt a big fiscal stimulus that has been shot down in flames by the UK's experiment. The LDI debacle is a salutary tale for what can happen when higher interest rates meet financial stability risks. The Bank of England was forced to step in and buy bonds just as they were about to start selling them. Andrew Hauser, Executive Director for Markets at the Bank, admitted that "at least some market participants initially thought that the Bank had really restarted QE". That's why Governor Bailey had to stick to his guns and end the intervention after two weeks, otherwise its credibility would have been shot to pieces.

But now the Bank is stuck as it must proceed with keeping a lid on inflation without blowing up any other financial market landmines. That's where the new government comes in. Rishi Sunak is just as scared about higher interest rates as he knows the huge pile of debt will cost more and more to service. No wonder that when he was Chancellor presiding over all of that debt that he told the Treasury Select Committee in March 2021 how the risk of rising interest rates was keeping him up at night.

Sunak fears debt as the enemy where Truss embraced growth as the goal. That means fiscal policy will be kept tight so that monetary policy can be marginally looser.

This brings the monetary and fiscal policymakers into a credibility doom loop. If fiscal rectitude cannot return, then monetary policy has to step in to ease policy just at the point where it must be tightened. But if monetary policy tightens too far then the government can't loosen fiscal policy to ease the pain. Both sides are now tied into the other. And if the events of recent weeks didn't make this clear enough, once credibility is lost it is very hard to regain.

The UK might have borne the brunt of this first but it's a problem across developed markets. Just how far can central banks squeeze up interest rates before either markets or economies (or both) collapse? And how much can fiscal policy ease the pain given the difficulty of governing such a divided electorate?

There is little room for manoeuvre. Financial markets had it easy in the great pandemic liquidity boom. Now the cheque has arrived and the price to pay will be reflected in lower risky asset prices.

# Geopolitics

## Ukraine

### Frozen conflict: The war grinds on

The war could end next year if the US and EU grow suddenly weary of supporting Ukraine, or if Kyiv retakes Crimea. But on balance it looks like the war will enter a kind of stalemate as Russia defends its Western defensive positions.

## Grey swans: The tail risks

What might happen to change the narrative? Whilst the macro-outlook looks reasonably well understood, if not terribly encouraging, there are a couple of potential grey swan events to look out for.

Three unlikely, but plausible, event

### Chinese invasion of Taiwan

Whilst a direct invasion of Taiwan by China seems plausible at some time in the future, it could happen as early as next year. This would be a surprise, with Pentagon officials believing China is not yet ready to launch a strike. However, recent purges of the CCP by leader Xi Jinping, replacing any and all rivals with loyalists, has prompted some to believe that China could head the way of Russia, with one man's poor judgment leading to war. Xi has basically told the US that Beijing will retake Taiwan and to back off. Surprise might be required and the backdrop of the Russian conflict in Ukraine might provide the necessary cover as China might judge errantly that the US would prefer to seek a face-saving way out of defending Taiwan.

### Putin toppled

Whilst the central thesis is that the war in Ukraine rumbles on, markets would undoubtedly cheer its end. At present the only way that could plausibly happen is for a toppling of Russian president Vladimir Putin

### US ends Ukraine support

On the other hand, there is a risk that the US ends military aid for Ukraine, which could result in a significant reduction in the country's operational capacity and effectiveness. Some Republican politicians have said the US should not pay any more. Whilst it seems very unlikely, especially given what the Republican leadership has said, the mood in Washington can change fast. A Republican-controlled House might be pickier about what money is spent on, but it is likely to stick to its ally.

# Social media upheaval

2023 may see some significant changes in the social media and tech space.

Elon Musk's acquisition of Twitter has already wrought some major changes at the world's 'digital town hall'. Advertisers are taking a step back and will continue to do so next year. Meanwhile TikTok could well be banned in the United States, which would be a major boost to the struggling Meta.

## TikTok banned

As part of the broadening of the information and trade wars being fought between the West and China, TikTok gets banned. Officials on both sides of the Atlantic have raised alarm at the passing of user data to China and its possible use by security services there. China-based employees of ByteDance, TikTok's parent company, have accessed non-public data about US users. TikTok has denied a report that a China-based team at ByteDance planned to use the app to track the locations of US citizens.

There is growing concern among US lawmakers and support for taking on TikTok seems to be building. In the wake of the midterm elections, Republican China hawks in the House of Representatives might push for an outright ban, or least a sale of its US business. FCC Commissioner Brendan Carr has called for its ban, and though the FCC cannot act alone, it shows the idea is gaining traction. In the UK, prime minister Rishi Sunak has taken a hard line against China, first with plans to ban the presence of Confucius Institutes in British universities. A US ban could easily be replicated in the UK and EU. This would have far-reaching consequences for Meta, Snap and other social media companies and digital advertisers.

## Stay and play? Twitter loses advertisers

Elon Musk surprised everyone when he finally bought his favourite Twitter. No one was very surprised that once he got his hands on his favourite toy he proceeded to break it. Advertisers have given the Tesla 'founder' a lukewarm reception. Although Twitter says there was a rise in activity in the first week since Musk took over, the platform runs the risk of becoming marginalised. Advertisers have been cautious and in 2023 there could well be an exodus. Large-scale sackings at Twitter might have some justification from a financial point of view, but it reduces the company's effectiveness at doing several important things. Musk will probably show that you can run a social media platform with substantially fewer staff, but it doesn't necessarily mean advertisers – who will be retrenching in 2023 anyway – will be on board.

Musk said, in a tweet: “Please note that Twitter will do lots of dumb things in coming months. We will keep what works & change what doesn’t.”

Elon Musk
@elonmusk

Please note that Twitter will do lots of dumb things in coming months.

We will keep what works & change what doesn’t.

4:44 pm · 9 Nov 2022 · Twitter for iPhone

40.3K Retweets 13.1K Quote Tweets 537K Likes

Advertisers are worried it could become a ‘free speech hell-scape'

Elon Musk
@elonmusk

My commitment to free speech extends even to not banning the account following my plane, even though that is a direct personal safety risk

12:30 am · 7 Nov 2022 · Twitter for iPhone

29K Retweets 6,661 Quote Tweets 398.1K Likes

Many have already left

Elon Musk
@elonmusk

Apple has mostly stopped advertising on Twitter. Do they hate free speech in America?

5:45 pm · 28 Nov 2022 · Twitter for iPhone

59.8K Retweets 15.2K Quote Tweets 564.6K Likes

It just doesn’t seem as fun as it used to

Elon Musk
@elonmusk

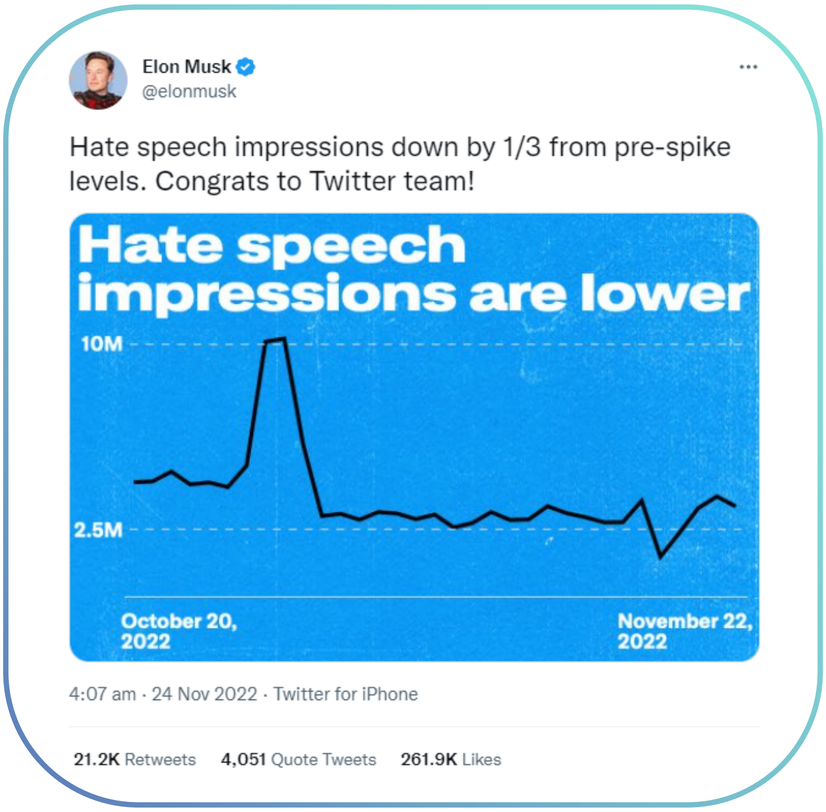
Going forward, accounts engaged in parody must include “parody” in their name, not just in bio

1:51 am · 11 Nov 2022 · Twitter for iPhone

28.8K Retweets 21.3K Quote Tweets 358.9K Likes

Musk even told employees Twitter could go bankrupt. And from here the financials don't seem to add up. Advertising revenue was around $4.3 billion a year. If that were to fall to say around $2.5bn, Twitter would need to sell 19m $8 subs to break even. Will people stay and pay? The problem is you have a maverick CEO and lots of other places where you can get in front of eyeballs – so why stick with Twitter? One reason might be to follow Donald Trump, but his reinstatement is as divisive as Musk's acquisition of the platform in the first place.

Musk though is adamant he's making progress




## Metaverse jam tomorrow

Investors will need to wait longer before Meta can turn its metaverse dreams into (virtual) reality. Reality Labs operating losses in 2023 will grow significantly year-over-year. And it's not just the $10bn+ cash burn on the Metaverse each year – overall expenses are soaring and seem to be getting out of control, with 2023 expenditure seen rising from around $86bn this year to between $96bn and $101bn. Q3 earnings spooked investors, but there are signs that Mark Zuckerberg is not prepared to drive the business into the ground in pursuit of his Metaverse dreams. Job cuts, stricter capital controls and a focus on key growth spots was announced in the wake of Q3 earnings after investors raised concerns. But this won't deliver the metaverse dream any quicker. Investors will need to remain patient, but hopeful. As Bill Gates said, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."

In fact, Apple is the one to watch in this space next year as it's set to launch a headset of its own. Apple is rarely first to market but it's usually pretty good at it.

# Crypto

## Crypto winter turns to Ice Age

The winds of the crypto winter are blowing hard. After a crash in prices earlier in 2022, crises from Luna and Celsius to FTX sent further shockwaves through the cryptocurrency market, leading to further deleveraging in the sector. 2022 exposed cryptocurrency as a liquidity-driven risk-correlated asset class, rather than a standalone macroeconomic hedge or mega bet on the future of finance and payments. The collapse of perceived strong hands like FTX poses grave questions about the viability of the entire system, which seems to have been, in the vast majority of cases, a venture capital funded pump-and-dump.

Ice age? Crypto cycles on average last for four years, so recovery may not be in the offing until 2026, if you assume this winter began in the summer of 2022. This would tally with the bearish thesis for risk assets based on a prolonged stagflationary episode for the global economy. One could go further; with underlying liquidity supporting the system drying up completely the entire asset class may become uninvestable and effectively die.

One thing that could cause the winter to thaw to a spring would be a major, globally coordinated regulatory overhaul of the entire sector by the G20. Suffice to say no one is touching this stuff now without it being fully regulated. India, which takes over the presidency of the G20 for one year, says crypto regulation would be a priority. The OECD has already submitted a framework to increase transparency in crypto to the G20, but a single set of global rules and regulations are a long way off. But more transparency around the balance sheet, holdings and counter-party risks of the major players left standing will only expose the emperor for having no clothes = crypto market to shrink further in 2023.

## El Salvador abandons bitcoin

The Legislative Assembly of El Salvador officially introduced bitcoin as legal tender in Q4 2021. The initiative was initially touted as a means of creating financial freedom for the Salvadoran people by its president, Nayib Bukele. However, while bitcoin has increasingly lost momentum, the crypto based dream has slowly become a nightmare. As the country continues to lose out on its currency experiment it becomes increasingly likely that Bukele may recant his commitment to bitcoin as one of El Salvador's official legal tenders.

El Salvador's Finance Minister Alejandro Zelaya continues to downplay the fiscal risks attached to the country's crypto portfolio. Nevertheless, with Bitcoin adoption plummeting amongst the Salvadorian people alongside its valuation, it is all but guaranteed that scrutiny surrounding the adoption extends beyond the closed doors of the quasi-authoritarian regime.

# Energy

## Where next for oil?

Oil prices surged in 2022, chiefly as a result of the Russian invasion of Ukraine. But since the initial spike the market has drifted lower. OPEC and allies, alarmed by the decline, cut output by 2m barrels a day to shore up prices. Russia's oil exports will fall by around 2 million barrels per day due to sanctions and restrictions on insurance and shipping. The US will not keep releasing stocks from its Strategic Petroleum Reserve and will need to refill it. Despite this, prices are seen falling in 2023. The World Bank says Brent crude will average $92 a barrel in 2023 before easing to $80 in 2024. Backwardation in the futures curve pointed to relatively benign market conditions, but the flip into contango in November highlighted stresses emerging. Expectations for a worldwide recession seem to be keeping a lid on oil prices and forecasts for demand growth, yet spot prices dropped below back-month futures.

But if China reopens and ends zero Covid policies it could drive prices higher, particularly as the market is set up for a slow move lower. Supply disruptions in Libya, Russia, Iraq, and Iran may also factor into higher crude prices next year. Meanwhile now Biden got what he wanted from the SPR (lower gas prices before the midterm elections), the SPR put in the market goes and prices may move up. China reopening would juice demand and also lower the USD, further boosting commodity prices, which in turn could lead to higher US inflation + Fed tightening. Cycle complete.

With contributions from BlondeMoney's Helen Thomas and Finalto's Zak Walker

From

Finalto

The Watchlist 2023

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