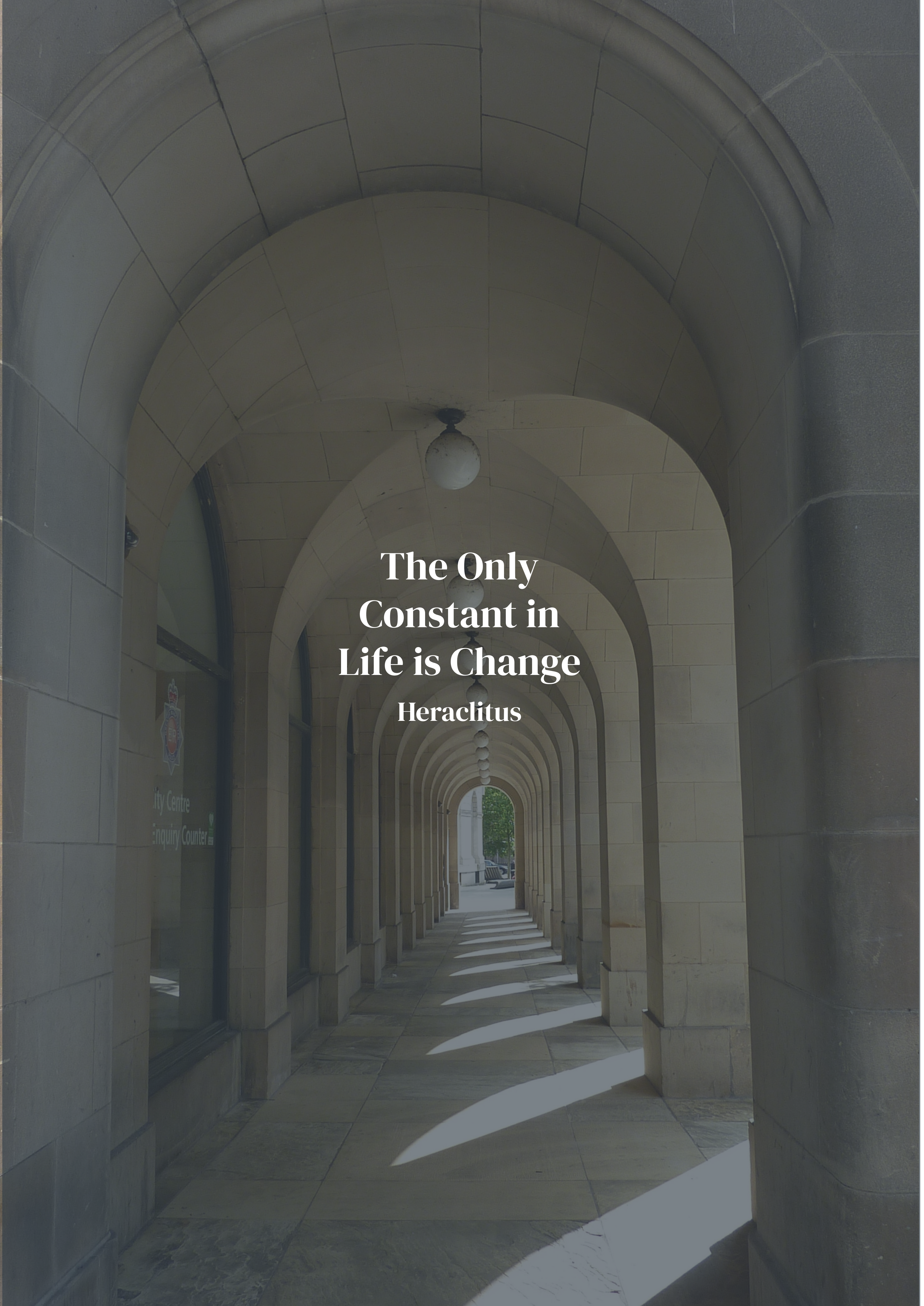
Luna Investment Management

2023 Outlook

The Only Constant in Life is Change



Introduction

Welcome to the 2023 Luna Outlook document, our annual commentary where we look at what to expect from the economy and markets in the next 12 months. We always try to start with a quote at the outset which encapsulates our views on the year ahead and for 2023 we have decided to delve into Greek philosophy; "The Only Constant in Life is Change" Heraclitus.

2022 was a year which witnessed strict Covid policies in China, a war within European borders which contributed to soaring inflation and central bankers being behind the curve which forced interest rates and the cost of borrowing higher.

When looking forward, it is important to see where we have been.

These topics will continue to dominate in the year to come but perhaps we could start to see some positivity. Inflation will likely moderate in the next year, with one of the key contributing factors, commodity prices, having fallen from early 2022 highs. However, it would be naive to think that we are going back to the world as we knew it.

Other cost pressures (e.g. mortgages) will be feeding through over the next few years which will further impact disposable income and weigh on a consumption-based economy.

As we look forward, we expect:

- Inflation will start to moderate as we move through 2023.
- The current outlook for global economic growth is likely to be below trend and recessionary in some countries.
- The Chinese economy reopening could be key for the global economy in 2023.
- Stock markets move ahead of the economy by six to twelve months.
- Central banks have increased interest rates significantly in 2022. Whilst they may continue to increase in early 2023 they are then expected to pause and perhaps start to fall later in the year.
- Valuations across asset classes are attractive after the falls in 2022.

UK Economy

As the UK heads into the year it is most likely already technically in recession, which is defined as two quarters of negative economic growth.

The economic outlook from the Bank of England and other government bodies does not make warm reading and it is expected to be a year of negative economic growth but only modestly so. We are seeing one of the biggest cost-of-living squeezes in a generation. Wage increases are not keeping up with inflation and the impact of this is we are all feeling poorer.

In 2023 it is likely this will continue but perhaps it will not be the shock it was in 2022. Energy bills are likely to stay high and there is also the possibility of an end to the government support package in April. As people come to the end of fixed rate mortgages then they will be refinancing at higher interest rates.

Covid restricted the way we lived our lives and our subsequent spending habits as individuals and companies could not spend and instead saved or paid down debt. This means both corporates and individuals are going into this squeeze in a strong position. As well as this, the UK employment market is in robust shape. We are close to the lowest levels of unemployment in 40 years and near to record job openings.

Further, the weak pound has been a positive for the main UK equity market. The FTSE 100 generates a significant proportion of revenue from overseas currencies which is a reason why sterling earnings have benefited. This is coupled with a high oil price and increasing interest rates from UK listed companies.

Global Economy

Whilst the UK outlook may look quite dark, the global economy looks set to fare slightly better in 2023, which is key for most major markets because we live in such a globalised world nowadays.

Starting off with the United States, the world's largest economy, we can see that it is clearly slowing. However, whilst the odds of a recession in 2023 have increased, growth currently remains positive.

The US faces similar inflationary challenges as the UK but the crucial difference that it is energy independent.

As we drew a close to last year, China announced sweeping reforms to their Covid strategy, which should stimulate the world's second largest economy.

This is a well-trodden path now; as countries implement Covid restrictions it negatively impacts their economy but as they gradually reopen it has the opposite acceleration effect.

Europe's fortunes look bleaker due to a reliance on Russian gas and oil. European consumers are going through similar pressures to those in the UK but their reliance on Russian pipelines creates more pressure.

Europe has managed to rely on gas from other areas this winter but this will be harder to repeat in 2023 with Chinese growth set to accelerate.

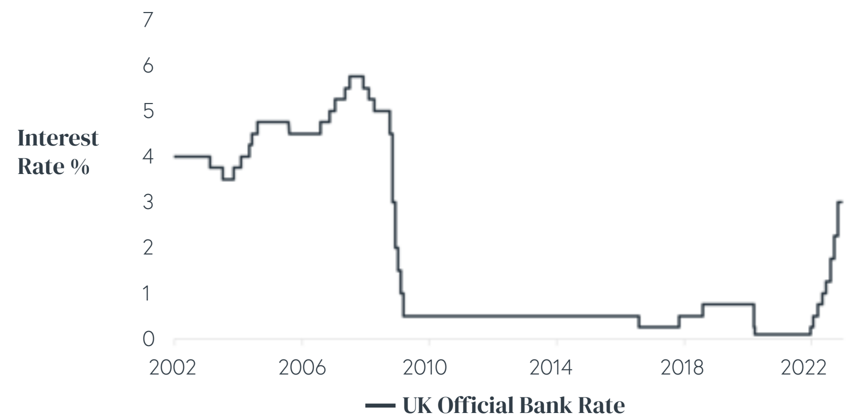
Interest Rates and Inflation

The UK moved interest rates from 0.25% to 3.5% in 2022. That is the highest level since the financial crisis in 2008 and one of the fastest rates of increase in the last 30 years. It was not just the Bank of England doing this, most major central banks increased interest rates in a fight against inflation.

It takes six to nine months for a move in interest rates to filter into the economy because it takes a while for the impact to be felt; for example, most people are on fixed rate mortgages and will not refinance straight away. This means that in 2023 we will start to feel the impact of the interest rate moves in 2022.

near to $140, whereas today it is closer to $80. Oil is not the only commodity being impacted by this pattern, big falls have been witnessed in the prices of iron ore and agricultural commodities. This should have a knock-on impact in supermarkets and restaurants in the coming months.

Global central banks are in a tricky place because they are trying to maintain moderate inflation AND keep the economy on track. Increasing interest rates combats inflation but with economic growth slowing, you would typically expect central banks to be cutting interest rates.



Source: Bank of England (January 2002 to December 2022)

There are some green shoots of positivity suggesting we are nearing the end of this inflationary period both in the US and Europe. Inflation has fallen in the US for the last five months and is in the process of gaining momentum. One of the reasons we feel inflation will start to moderate is because of the way it is calculated, i.e. annually, where the inflation calculation compares today's prices to those from a year ago.

As we move through 2023, inflation will reflect the high commodity prices that immediately followed Russia's invasion of Ukraine. To highlight this, at its peak in March the price of a barrel of oil was

During 2023 inflation will likely moderate for the reasons outlined above but economic growth may also weaken. Therefore, central banks' attention is likely to shift from combating inflation to supporting the economy and in doing so the risk of interest rates increasing looks unlikely. The base case is that interest rates are held close to current levels and could start to fall as we get closer to the end of the year, dependent on the path of the global economy.

Interest rates and inflation was one of the key headwinds into 2022 and a more stable monetary policy will be welcomed by individuals and markets.

Valuations

2022 was a tough year for almost all asset classes. However, as we enter 2023 the landscape is completely different:

- Cash now earns a return with interest rates moving higher.
- Government bonds have the highest yield for a decade.
- Corporate bonds provide an attractive yield above government bonds.
- Global equity markets have fallen, some more than others.
- The UK FTSE All Share is valued at close to record lows on a Price to Earnings basis.
- UK Mid and Smaller Cap Companies share prices have fallen heavily compared to their larger company peers and seem to have priced in a mild recession.
- Investment Trusts have fallen in value leaving them on wide discounts to their net asset value and at attractive levels.
- Alternative asset classes, such as property, have already fallen significantly to reflect the slowing economic backdrop and higher interest rates.

Despite valuations being cheaper this does not necessarily always mean that markets will bounce from these levels. Valuations tend to be a good indicator over the medium to longer term but not in the short term. Therefore, patience is required and a focus on longer term investment goals.

Energy Transition

One of the big developments in 2022 was the realisation of the western world's reliance on politically unstable countries for the provision of natural gas and oil.

The cost of petrol and electricity is headline news, as environmental pressure groups and politicians continue down the path to a carbon neutral world by 2030 in many countries.

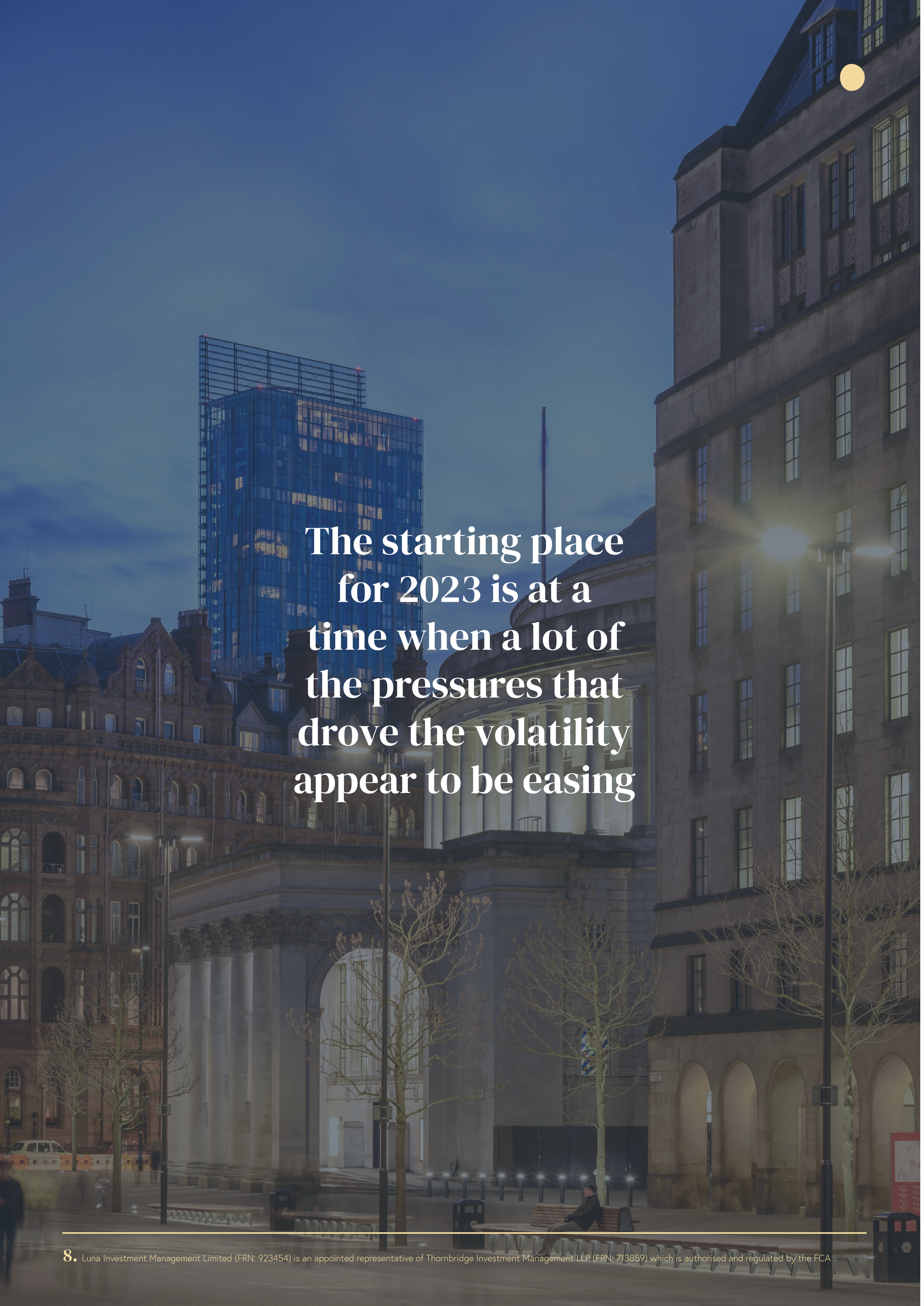
The goal comes from the idea that industrial activity destroys the planet and the energy that is being used must be dramatically reduced and be replaced by 'clean' energy. We agree that as a collective we need to treat Mother Earth with respect and employ the full force of technological change to advance shifts in how we power the world.

Currently the goal appears to lack clarity on how to replace natural gas coupled with the long lead time to implement such a dramatic change. Energy is critical, not least to the poorest in our society who are disproportionately impacted by high energy costs.

The requirements to meet this transition and to decarbonise the electricity grid are enormous compared to what has taken place so far in terms of mining and grid infrastructure reform. That the transition needs to take place in an 'anti-development' environment and on a shortened time-scale makes the goal even harder and increases the costs.

The unique assets in the form of the oil and mining majors that are listed in London have critical roles to play in achieving these objectives. These companies are at the forefront of developing new technologies, such as bio-gas, on a commercial scale.

Despite the strong returns last year, these businesses can still be bought cheaply on single digit Pricing to Earnings ratio and at attractive dividend yields. Investors can be paid to wait, whilst actively supporting the energy transition which will struggle to be achieved without these companies.



The starting place for 2023 is at a time when a lot of the pressures that drove the volatility appear to be easing

Focussing on Quality

We have been used to a world of very cheap money since the financial crisis but that changed in 2022.

It is not just individuals that will be impacted by higher borrowing costs in 2023, corporates will be too. For this reason, we continue to focus on companies which have strong balance sheets and low levels of debt.

Another key quality trait we look for when selecting businesses is their margins. High margins provide protection to businesses.

Margins are under pressure pretty much everywhere ok with wages moving higher and input costs rising. Companies that have high margins can withstand more of these pressures.

Further, management credibility is an important feature of quality investing.

We believe these features give these companies a competitive advantage and a reason for owning such companies for the long term.

Final Thoughts

2022 was an incredibly challenging year for markets, with big gyrations in both directions and across all asset classes.

The starting place for 2023 is at a time when a lot of the pressures that drove the volatility appear to be easing; the China Covid strategy, inflation and interest rates. On top of this, as we have outlined, valuations are at one of the most attractive points observed over the last 20 years.

Markets move ahead of the economy; this tends to be between six and twelve months. This means that it can feel pretty awful at ground level but markets can perform strongly. In fact, some of the best equity market returns are when economies are in recession.

Over recent history this has been observed on several occasions:

- In March 2020 the stock market bottomed the same day as the national lockdown was announced. It was only in November 2020 that the Covid vaccine and light at the end of the tunnel emerged.
- In March 2009 the stock market bottomed after the financial crisis, yet the economy didn't exit recession until the end of that very same year.

We note that our experience over the longer term is that valuation beats investor sentiment.

Equities are rarely a bargain when the backdrop is positive and we know that the market consensus has a focus on the near term. When the headline news is largely negative this is reflected in share prices and valuations.

If the environment in the UK becomes better, the improvement in sentiment towards UK equities from overseas investors may continue, giving investors optimism as we enter 2023.

The Luna Team

Our team of investment management professionals has over 200 years' combined experience, having managed more than £1bn of client investments. Each member of the team has been specifically recruited to deliver the high level of personal service and bespoke investment solutions that we believe our clients deserve.

James Carter
Investment Director

James is one of the Founders of Luna and is the lead Investment Director, with responsibility for devising and delivering the Luna investment management proposition.

Ed Maxwell
Investment Director

Ed is an Investment Director at Luna, part of the executive management team and a member of the Investment Committee.

Alex Brandreth
Chief Investment Officer

Alex is responsible for coordinating the overall investment strategy at Luna. He is also the lead Fund Manager on the Luna Model Portfolio Service.

Barrie Charnley
Senior Investment Manager

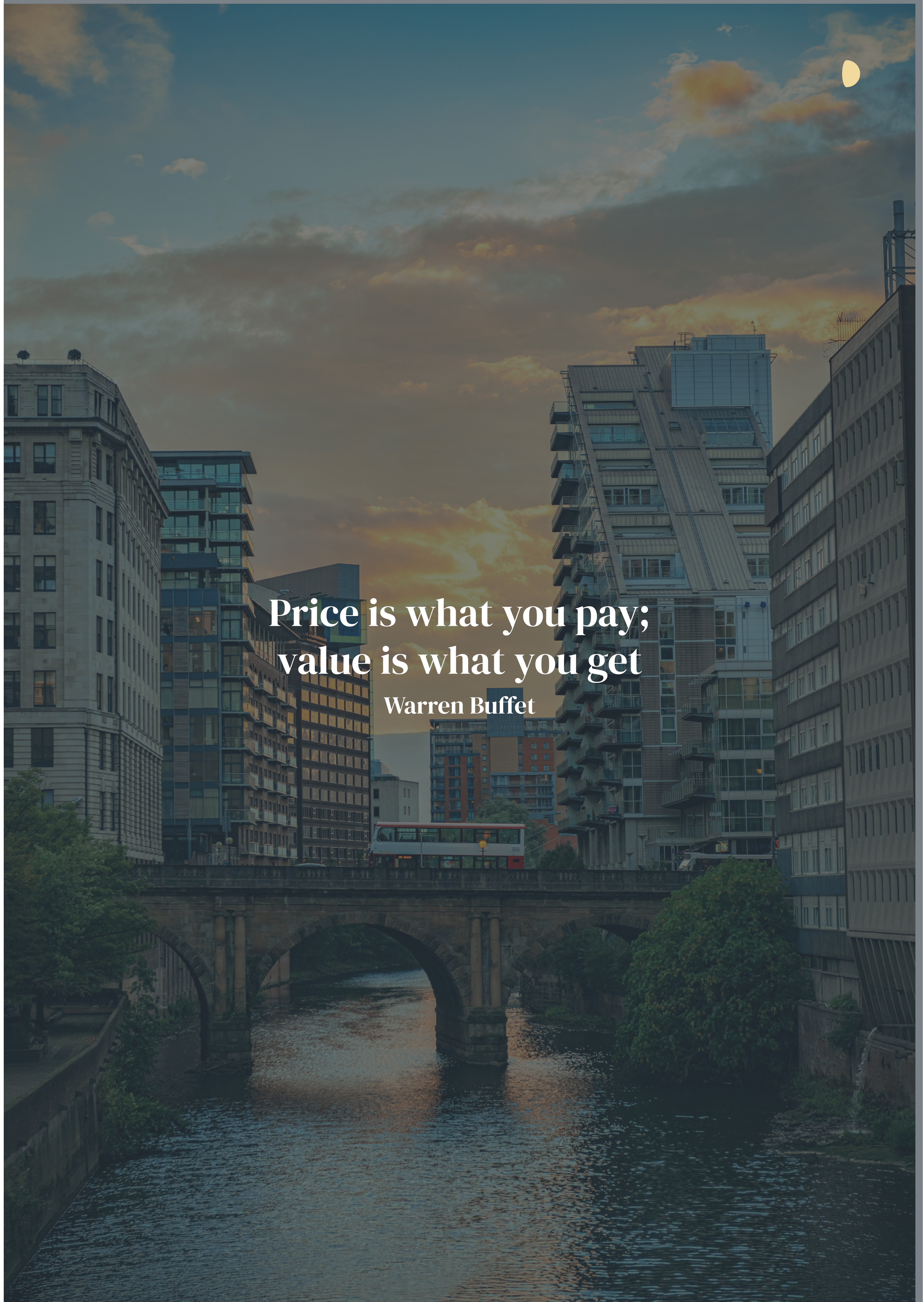
Barrie joined Luna as a Senior Investment Manager in June 2020. He works closely alongside the Investment Directors to ensure bespoke solutions are delivered within the wider investment framework.

Peter Stiles
Investment Director

Peter began his financial services career in 1985. He uses the knowledge and experience gained over this time to help shape and implement Luna's investment management proposition.

Ben Eardley
Investment Manager

Ben performs an important role at Luna in the management of client portfolios, ensuring they are in keeping with each investor's specific objective and risk tolerance.



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