THE BROKEN CLOCK SYNDROME AND THE OPEN PROSPECTS OF 2023

The only ones who have been correct in their predictions on the performance of financial assets in 2022 are essentially those analysts who are victims of the broken clock syndrome. These are people who, even starting from different macroeconomic reasoning, come to the same incontrovertible conclusion: markets are destined to fall because they are inherently unstable. Their prediction never changes from year to year. And like old, broken analogue clocks, twice a day, every day, they are extremely accurate, even if they are silent in the remaining time. But 2022 was certainly their year. Almost everyone else got it wrong, be it the chief strategists of the world's most important banks, the Wall Street elite working in the 'smartest funds', or even the central banks that, at least in theory, should hold the most sophisticated tools for interpreting and directing market trends. Such a widely shared error cannot go unnoticed. It is no longer just a matter of judging the superficiality or incompetence of the individual (although some have put their own spin on it). The global inability to grasp, at least in part, the signals that the market constantly expresses can only be the expression of a systemic, not to say paradigmatic, transformation.

Economic science has made major efforts to model macroeconomics. Sophisticated new econometric calculations, fed into a supercomputer, were thought to be able to illuminate, even in predictive terms, variables such as the growth of Gross Domestic Product (GDP), inflation, unemployment and the correlations of these variables with the money supply. But this was not the case in 2022. Now economists will have to ask themselves whether quantitative finance can exist as it is, thinking that mathematics has made it a science akin to physics. Or whether they should instead return to a more holistic approach, rediscovering the logical methods of philosophy (from which it has detached itself) and retracing experiences such as those of the French Nouvelle Histoire, which had incorporated the social sciences into historical analysis. This is not to say that econometric models should be abandoned. Rather, it is their premises that need to be set according to broader assessments, in order to avoid the ideological prisons on which the models themselves are then built. Those suffering from the broken clock syndrome, who often display profound analytical skills, then stumble over a crucial aspect: it is not only they who see the problems. There are also private and institutional figures who counteract them. Those who are best able to interpret current trends must also be able to anticipate the reactions that are produced. What to do in the meantime? Bow to the broken clock syndrome so that every now and then you get it right? Or simply search among the mass of available information for those elements that define a trend, trying to understand when the substance changes and thus a trend breaks down?

At the end of 2021, despite the fact that financial assets had strengthened strongly, we prepared for the new year with moderate optimism. Certainly one did not expect a repeat of the fine post-pandemic performance, precisely because of the valuations achieved. But one was convinced that generous fiscal policies would stimulate growth, because in the debt/GDP ratio, States, indebted beyond measure due to health restrictions, would have emphasised GDP growth precisely so as not to have to put their hands on debt, which would have then eventually remained sustainable. The fact of still living in a world of moderate inflation would have made it possible to use the leverage of debt to finance - for free, since rates were close to zero or even negative – for the new de-carbonised digital economy. This seemed to benefit from the indirect effects of Covid, which had forced more production with less personnel and more digitisation, making economies more productive.

Of course, it was clear that money could not be printed indefinitely and that, first and foremost, the Federal Reserve would begin to drain some of the enormous liquidity injected into the market. But the markets hoped that China would take the reverse route. Having benefited in 2021 from the effects of the huge mass of liquidity produced by Western central banks (including Japan), it would provide it the following year, effectively helping the world economy to stay on a growth path. Especially since inflation was not a problem for Xi Jinping's country. Larry Summers himself, an economist much listened to on Wall Street and by the US administration, confirmed the need for this hope, warning the world that without China's support it would be difficult to avoid recession in the US.

This scenario was disrupted by geopolitics, which immediately spilled over into macroeconomics. On 24 February 2022, Russia attacks Ukraine. It is the challenge of the old economy, made up of real goods, oil and gas, wheat and steel, to the new digitised and green economy that Joe Biden's United States and the European Union intend to ride with renewed power. The effect of this clash manifests itself in the bloody battlefields, hitting the Ukrainian people with ferocity. But it also has economic consequences with resounding worldwide effects: the resurgence of inflation, with even double-digit rates, even in Western economies, particularly in the United States and the European Union. The central banks, whose independence is beginning to give mixed signals, are hesitating to recognise that a new phase has begun, characterised by inflation rates to which they have not been accustomed for decades. Perhaps never before has inflation been a powerful instrument of war in the battle between the US and its allies against Russia with its not a few sympathisers, via Ukraine. The econometric models were clearly not calibrated to the political risk of generalised price increases.

Inflation becomes a tool to target the world's dominant currency, hence the United States, in a context where other political and currency poles - led by China, but not only China - are trying to counter its dominance. The US is becoming aware of what is at stake: defeating inflation has become the top strategic priority in 2022. It is vital to prove to the world that the greenback, despite high levels of debt, is the currency where it is best to take refuge because it is wealth preserving, reliable and easily traded. Behind the currency is the strength of the country, its commercial and military power. In a new international context where the US is no longer an absolute but a relative power, the role of the dollar is even more decisive. Thus, in 2022, the Federal Reserve has racked up a series of manoeuvres not seen since the 1970s, when Paul Volker was at the head of this institution. Interest rates rose from zero to 4.25-4.5% over the course of the year and expectations go beyond 5% in 2023. Naturally, such a massive operation pushed the dollar to strengthen against most currencies.

The resurgent inflation has several causes. The first has to do with pandemic economics, which has defined the strong support for aggregate demand in many countries and the sequence of difficulties in the supply of products (factories and trade blocked by Covid); the second stems from the war in Ukraine with the rise in commodity prices (especially energy) and the costs of the new arms race. But already with the presidency of Donald Trump, who wanted to lay the foundations for the downsizing of globalisation, its contours were already emerging. The ageing of the population is another megatrend, which leads one to imagine wages rising in view of the shrinking labour force. Nevertheless, the Federal Reserve initially called inflation transitory, then sticky, before resigning itself to seeing it as a major threat to purchasing power and the stability of the dollar, to the point of considering recession, even heavy recession if necessary, the lesser evil. Nouriel Roubini extends the central banks' reasoning as, according to him, 'structural trends suggest that the problem will be secular rather than transitory'. [1] Roubini, who very lucidly announced the severe financial crisis of 2008, is generally seen as a great pessimist. But it would be excessive to consider him a victim of the broken clock syndrome. According to the economics professor, in the current context, "many countries are engaged in various 'wars' - some real, some metaphorical - that will lead to higher fiscal deficits, further monetisation of debt, and higher inflation. The world is moving towards a form of 'geopolitical depression' topped by escalating rivalry between the West and aligned (if not allied) revisionist powers such as China, Russia, Iran, North Korea, and Pakistan".[2]

The markets, in 2022, became aware of these risks. They also realised that the energy transition that had been much talked about - and gambled on - in 2021, opening the doors of the world media to a very young Greta Thunberg, was losing all its lustre. Inflation, exacerbated by the war

[1] Nouriel Roubini, “More War Means More Inflation”, *Project-Syndicate.org*, 30 dicembre 2022.

[2] Ibidem.

in Ukraine, effectively undermined the possibility of financing the fight against climate change with zero-interest levers. Investor interest shifted from new economy stocks to energy and defence stocks. Basically, world stock markets lost around 20% last year. The US S&P fell by 18% and the flagship index of the new economy, the Nasdaq, by 30%. Even Europe, which was more directly affected by the energy crisis, managed to close the year at around -10%, after hitting major lows. A scenario similar to that of China (Hang Seng -10% and CSI -20%). But the biggest losses were recorded in the bond world: the Bloomberg Global Aggregate Index fell by over 18%. There was therefore no salvation in balanced management either, as both bonds and equities suffered in tandem. At the currency level, the dollar was the undisputed protagonist, thanks to the continuous rise in rates, but also to the fact that 5-year inflation expectations remained around 2.5%, while the 5-year treasury yields almost 4%, thus discounting a positive real yield in the long term. Gold only managed in the last months of the year to reverse its losses. The Federal Reserve's decision to show the world that it is prepared to accept even a heavy recession, if necessary, in order to fight inflation hard, pushed oil and gas prices down. China's Covid restrictions have also contributed to the global economic slowdown, hence the need for hydrocarbons and commodities.

Probably never before has the slowdown of the world economy been so widely predicted as in 2023. So much so that most analysts are convinced that stock markets will fall in the first part of the year, punished by expectations of recession, and then rise again as rates hit highs, the economy lows, the trajectory of inflation reverses, and the Fed perhaps even begins to reduce the cost of money, fuelling a stock market rally ahead of the 2024 US presidential year. Eight investment strategists surveyed by Barron's magazine (19 December 2022 edition) espouse this scenario, predicting, on average, a year-end close of the S&P at 4233, a gain of close to 10%. Indeed, despite the most violent monetary tightening in a generation, the US economy enters 2023 in decent shape. Growth remains robust, consumers have savings to spend, and corporate profits are at high levels. Employment remains strong, which is bad for the markets. In the

US, analysts therefore expect a soft landing rather than a deep recession. If this is the case, the S&P, the world's flagship index, is not expected to break support at 3500 (from 3800 currently). But it will be the bond markets that will set the pace as well. After the rate hike frenzy that hit the world in 2022, it is possible that the bulk of the path has been discounted. Rather, it will be necessary to be alert to the course of the curve, as attempts to reduce the central banks' copious balance sheets will be reinforced. There is probably some good news for balanced portfolios: the bond part, after almost fifteen years, is becoming attractive again with average yields between 4% in the US and 2% in Europe, and should still support performance. If bonds have already really discounted most of the rate rises, equity markets should also not be far off their lows: the risk of a fall would stop at around 3,500 points for the S&P.

Such linear forecasts are risky in any case for 2023. We are still at the intersection of two types of economies: the Covid economy and the war economy, both of which are inherently inflationary. The pandemic seems to be coming under control, but not yet in China. Xi Jinping's country will still be important for the growth/inflation ratio. Its recent opening can be a big contribution to world growth and is again attractive in portfolios. However, it should not be an overwhelming awakening, given its many domestic problems. But it will certainly have an impact on growth, especially in Asia, and on inflation through increased demand for raw materials and energy.

Europe is the region most directly affected by the war in Ukraine. The cost of energy is a high-risk inflation factor. Although it seems that acquired gas reserves and a mild winter may have alleviated - for now - the pain; but structural deficits remain high. The break with Russia forces the country to review the sourcing of its energy sources with costs that will remain significant in the future. It will also have to juggle at currency level, given the indebtedness of some of its members, such as Italy, which will act heavily to avoid too marked rate rises. The low euro helps exports, especially if China rebounds, but at the same time, through it, inflation is imported. The risk of triggering an upward spiral in the cost of living is significant, making the European central bank very uncomfortable. The markets know this.

But the low multiples of the Eurostoxx and the tradition of high dividends in some sectors (banks, utilities, insurance, pharmaceuticals) will contain stock market declines. The same goes for England, whose indices are composed of energy companies and commodity producers with good dividends.

Japan, thanks to the devaluation of the yen and low inflation, managed to contain its stock market losses in 2022. Now that prices are starting to rise, also in its domestic market, it is changing policy and acting on rates. The yen's appreciation against the US dollar will also have an impact on US treasury bonds and carry trades (debt in yen to invest in dollars at higher yields), which will also contribute to the greenback's strength against the euro over the course of the year.

Underlying the uncertainties for 2023 are fears that restoring normalcy - after fifteen years of negative real rates in advanced economies - could be extremely complex and require maintaining a restrictive monetary policy "for a longer period than many policymakers and market participants seem to expect".[3]

This becomes even more significant when one considers the political will to defend the dollar's role as the world's reserve currency. But on the other hand, one has to assess how far the central banks, and in particular the Fed, are able to guarantee the necessary firmness in their trajectory. The fact that they have refrained from giving forward guidance probably indicates their willingness to keep wide margins of manoeuvre to intervene in the event of exaggerated stock market crashes or, as happened in England, extreme volatility in government debt. The context remains the inflationary context of war. And for this reason, above all, a break of the 3'500 in the S&P cannot be ruled out (the other important technical support is near the lows of the 2020 pandemic). But a lot of black swans have accumulated in 2022. It would only take a single white swan, alongside the great efforts already made to contain inflation, to restore optimism in the markets. In 2023 it is therefore necessary to keep an open position, because there will be no shortage

[3] Carmen M. Reinhart," Le banche centrali saranno in grado di fare quello che serve all'economia? Tassi, inflazione e finanza globale", *Il sole 24 Ore*, 3 gennaio 2023.

of surprises. The fact that many are negative could indicate that the market has already discounted the ugly. One must therefore be ready for sudden turns, taking advantage of moments of negativity to selectively accumulate risk in portfolios. At this early stage of the year, however, it is best to keep one's guard up with value stocks with good dividends and solid cash flows and with bonds of moderate quality and duration.

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