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2023 Global multi-asset outlook

Entering the uncharted territory of a multi-polar world

By the Multi-Asset Team
December 2022

Opportunities emerging, still-troubled waters to navigate

2022 is best forgotten, period. Still, for those in the capital markets, it never will be forgotten, nor should it be, for the valuable lessons learned. Inflation is back with a vengeance, reflected in deep pain across all asset classes—particularly when mixed with the fast removal of excessively easy policies that lasted more than a decade, punctuated with the massive monetary and fiscal stimulus that followed COVID. To be sure, the Federal Reserve (Fed) and other policymakers blew twin bubbles in the bond and equity markets and while the worst of the adjustment may be behind us, the repercussions and aftereffects will likely be with us for years. Of course, the many affected by the human tragedy of the Russia-Ukraine war will also not forget 2022, and our prayers go to those caught in the cross-hairs—hopefully with some form of resolution that brings a better 2023.

We do see an emerging landscape of interesting opportunities where depressed assets look cheap relative to better opportunities ahead. China appears to be finally moving past zero tolerance for COVID while lending better policy support for growth as the epic rise in the US dollar appears to finally be behind us. This twin dynamic lends oxygen to the rest of the world where asset prices have been badly beaten down. This often proves to be the case when China demand disappoints and Fed tightening results in a strong dollar that amounts to effective tightening around the world.

Even still, oxygen to the rest of the world in the form of better demand from China and a weaker dollar must be weighed against weakening demand from the US and elsewhere where tight policies begin to have an impact. Where does the balance sit? It really depends on the extent of the US slowdown and/or the depths of a US recession. Our base case is that a recession is likely, but more on the moderate side of the scale because cash is savings is still relatively ample and leverage is light in the private sector while labour dynamics have remained supportive (albeit, representing part of the stickiness of inflation).

The above-described tug-of-war global growth dynamics are likely to keep volatility elevated, and so will the trajectory of inflation as well as earnings that suffer from weaker demand. Deglobalisation is accelerating with the Russia-Ukraine war virtually assuring us that normal patterns of supply and demand will not be returning any time soon. We are optimistic, particularly given the outside compression in valuations around the world, but we also stay cautious for some of the uncharted waters ahead.

The following are some of the key themes that we are currently monitoring for 2023:

- **China demand to improve:** In 2021, we wrote on this theme and were quite shocked to the extent that China prolonged its zero-COVID policy while being slow to stimulate growth. However, different today is the fact that vaccination rates are much higher, knowledge concerning the virus is much deeper, and importantly authorities are feeling the pressure to shift given the growth weakness at home and a populous that is growing quite weary of the repeated and lengthy lockdowns. It may take some time yet to fully transition, but the prospects for improving China demand certainly help the growth prospects in the rest of Asia and beyond.

- **Inflation to ease, but 2% target will prove challenging:** inflation should naturally ebb from here, particularly when demand weakens in earnest. However, supply-side dynamics are unlikely to allow inflation to recede to historical norms of 2%. It is difficult to say when this dynamic may become apparent given the unknown contours of the coming slowdown, but we suspect that the Fed and investors will have to grapple with this issue in late 2023 or 2024. If growth is weak while inflation remains uncomfortably high, the Fed will have to make some difficult choices.

- **Weaker dollar:** The combination of rising US rates and still superior relative growth kept the US dollar strong for most of 2022, but the tide is beginning to turn. While the Fed has done little to shift from its very hawkish stance, a combination of better growth prospects outside of the US (think China) and tight policy slowing growth in the US supports a weaker dollar. Moreover, this dynamic is usually self-reinforcing given the likely shift in capital flows from the US equity market to other markets around the world that are far cheaper and potentially more attractive for the better growth dynamics.

- **Weaker earnings in the US:** While US equities appear to be performing relatively well in the latest rally from the October 2022 bottom, the outlook for earnings is less positive given that weaker growth ultimately transmits to weaker demand and earnings. US equities experienced outsized earnings growth and expansion in price-multiples following the COVID-stimulus and while the latter has corrected, we do expect weakness in the former in the months ahead. Of course, weaker US demand weighs on the rest of the world, so the key signpost is the extent of the weakness in demand.

- **Nuanced view on duration:** while bonds have begun to rally on the prospect of weaker US growth that has yet to fully manifest, the curve has inverted while the Fed has remained steadfast in its resolve to lift rates higher and leave them there longer than what markets are currently. Which is correct? It is hard to say, but duration is a natural hedge to weaker growth in earnings, so some duration makes sense in a portfolio context.

- **Scope for Russia-Ukraine resolution?** The war is troubling on many levels, but we do see scope for some form agreement given the escalating human cost, obviously the worst being in the conflict zone, but also the indirect costs mainly shouldered by the people of Europe in the form of sky-high energy costs and shortages that is quite substantial. At least on the surface, it looks like NATO members are starting to entertain the notion of how to end it, which would be a huge positive for 2023.

- **Multi-polar investing sees new winners:** Deglobalisation began with US-China trade wars in 2018 and accelerated with the supply-chain crisis of COVID, but international trust and allegiances have indelibly changed since the outbreak of the Russia-Ukraine war. This dynamic coupled with the ongoing effort fight climate change brings new opportunities in the form of investment (think industrials, pick & shovel), but it also ushers in structural inflationary pressures and risks of and intentional or unintentional military escalation.

Asset class outlook

Equities: The outlook for equities is positive but nuanced where value opportunities that have been excessively depressed in the midst of a strong US dollar and slow China demand may see the highest rewards in light of the shift of these previous headwinds turning to tailwinds. We prefer equities less vulnerable to easing demand from the US, which includes reasonably priced non-cyclicals in the US and those geographies with sector compositions that are better exposed to the shift in global growth dynamics.

Commodity-linked equities make sense for valuations and earnings outlook in light of ongoing limited production capacity, but this favourable supply-side dynamic must be weighed against the demand side which balances between slowing demand in the US versus improving demand from China and elsewhere. Europe hinges on the war where we see upside if and when firm steps are taken to a resolution and ceasefire.

Sovereign bonds: Developed market sovereigns look rich relative to the Fed's plans to tight considerably above the current 10-year Treasury yield, but it will take time to determine whether growth slows to the extent that bonds are pricing or whether the Fed is correct that rates will go higher and stay higher for longer. Nevertheless, bonds are a natural hedge to equities that face slowing demand and earnings in the US. We are more constructive on emerging market bonds where policymakers have stayed vigilant in hiking rates to match inflation dynamics, which are currently ebbing. We are less constructive on China bonds for the improving growth dynamics though the exposure does still serve as a proper hedge against growth disappointment in the region.

Credit: We are less constructive on credit mainly for the deteriorating growth dynamics in the US and Europe. Credit has been amply supplied post COVID, but instead of speculative investment, many used the proceeds to add to balance sheet strength. It is difficult to know where trouble spots may lie, but obviously weaker balance sheets that are more sensitive to slowing growth and rising rates are an important watchpoint to see if problem spots emerge that could have knock-on effects across the complex.

Conclusion

On balance, we are constructive mainly for valuation support and growth prospects improving for China with a firm tailwind from an easing dollar. Pockets of the US equity market may struggle on weaker earnings, but the rest of the world should still fair relatively well provided the US does not enter a deep recession (i.e., a hard landing scenario). Because balance sheets across the private sector are quite strong, particularly when compared to earlier credit crises like the GFC, it seems the likelihood of a hard landing are small. Still the unintended consequences of the stimulus excess and its removal can reveal itself in unforeseen pockets of the market (like UK pension plans needing a rescue in October 2022). Risks are abundant as the world enters uncharted territory of a multi-polar world while also weaning itself from stimulus excesses never before seen. As always, it will be important to stay vigilant to understand these fluid risk dynamics as they unfold and protect accordingly.

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