2023 Investment Outlook - What we are watching…

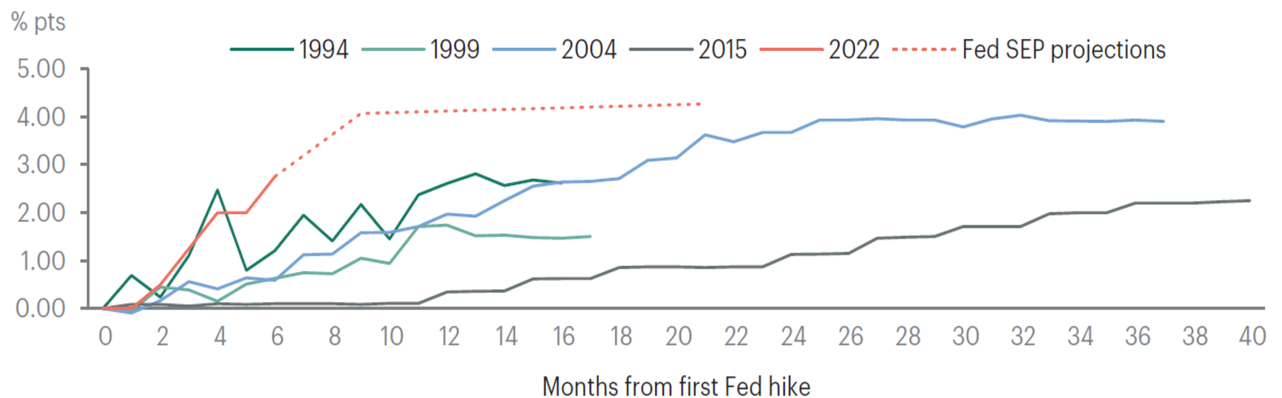
Investors are weary and battered after the disastrous performance of 60/40 portfolios in 2022. Inflation fighting by the Fed and other Central Banks increased the correlation across asset classes and the unprecedented pace with which monetary policy turned restrictive left investors with little scope for effective diversification through the year.

Now as we turn our attention to 2023, we would like to share with you the following key investment themes and associated dataflow that we will be watching carefully throughout the year:

- **Will Restrictive Monetary Policy Result in a Hard or Soft Landing?**

    - Fig 1 indicates that the Fed has been extremely aggressive in the current fight against inflation and market expectations are for policy rates to remain elevated for some time. With 2023 recession probabilities (Fig 2) above 50% in all major DM economies, it is clear that restrictive monetary policy is already cooling the economy and taming inflation. The Fed started raising rates in March 2022 and generally it takes 12 to 18 months for the maximum effect to be felt on the economy.

Fig 1: Fed Tightening Cycles (Change in Fed Funds Rate)



Source: US Federal Reserve; Bloomberg

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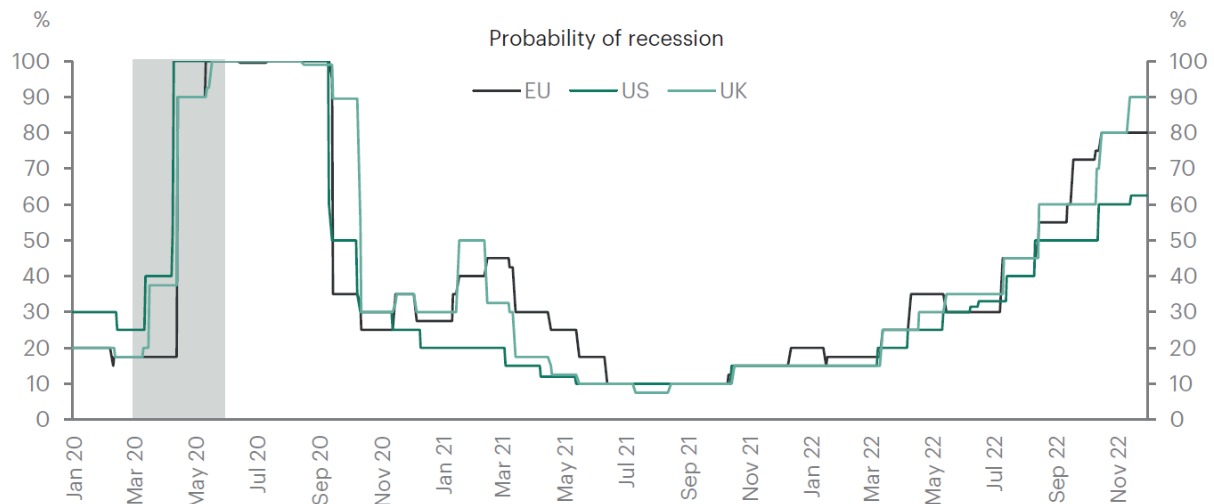
Fig 2: Consensus Probability of Recession within 12 months



Source: Bloomberg, Apollo Investments

- We continue to look at indicators on Monetary policy and how it is operating to cool the economy and tame inflation. Specifically, we continue to monitor the following channels all of which indicate that monetary policy is working:
  - Interest sensitive components of GDP are slowing sharply (Housing, Autos, Capex etc.);
  - Turmoil in the Technology sector given the relatively long horizon on earnings and higher risk-free rates;
  - High yield debt markets have essentially been closed to issuing firms in goods and service sectors.

- In our view, the key to whether the Fed can generate a hard or soft landing lies in the labour market and private sector balance sheets. Lingering effects of the Pandemic are affecting labour market indicators. The post-pandemic shortage of workers in the US is evident from Fig 3 which is contributing to labour market tightness.

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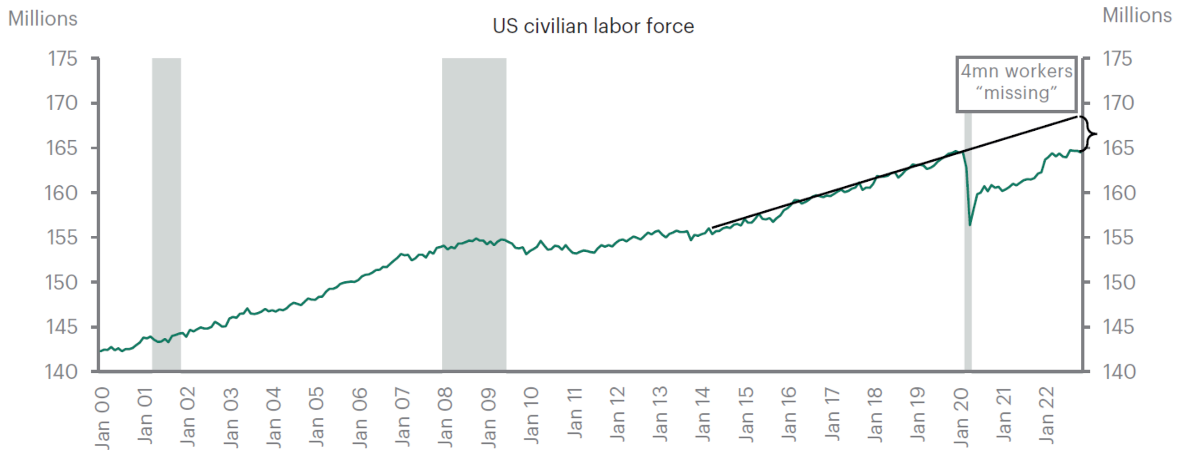
Fig 3: US Labour Force well below Pre-Pandemic Levels



Source: Bureau of Labour Statistics

The gap between job openings and available workers is also a crucial indicator of labour market tightness and these data (Fig 4) suggest that the most likely adjustment to tighter monetary policy will be a continued reduction in job openings rather than a significant increase in job losses. Should the job openings/worker gap continue to decline towards 2 million, any upward pressure on wages would be significantly reduced. Assuming inflationary pressures continue to unwind and labour market pressures ease with a reduction in job openings as opposed to firings, this would increase probability of a soft landing scenario.

Private sector balance sheets are also important as to whether the income sapping effects of elevated inflation and interest rates generate a hard or soft landing in the US and global economy. The data on US savings (Fig 5) point to about USD3trn of excess savings in US deposit accounts compared to the pre-pandemic trend. Assuming inflation continues to unwind, it is conceivable that monetary policy can remain restrictive while engineering a soft landing. This would be a very positive scenario for equities in 2023.

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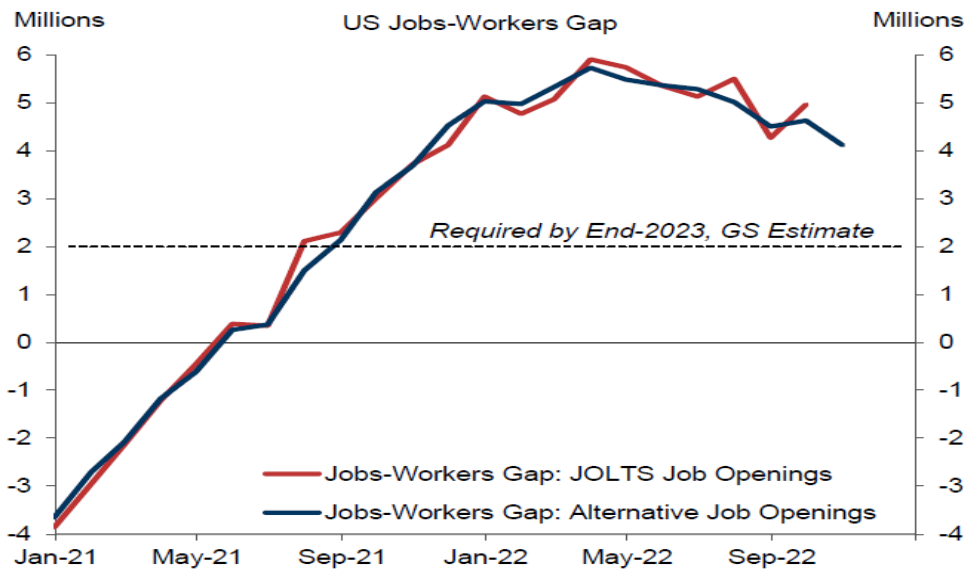
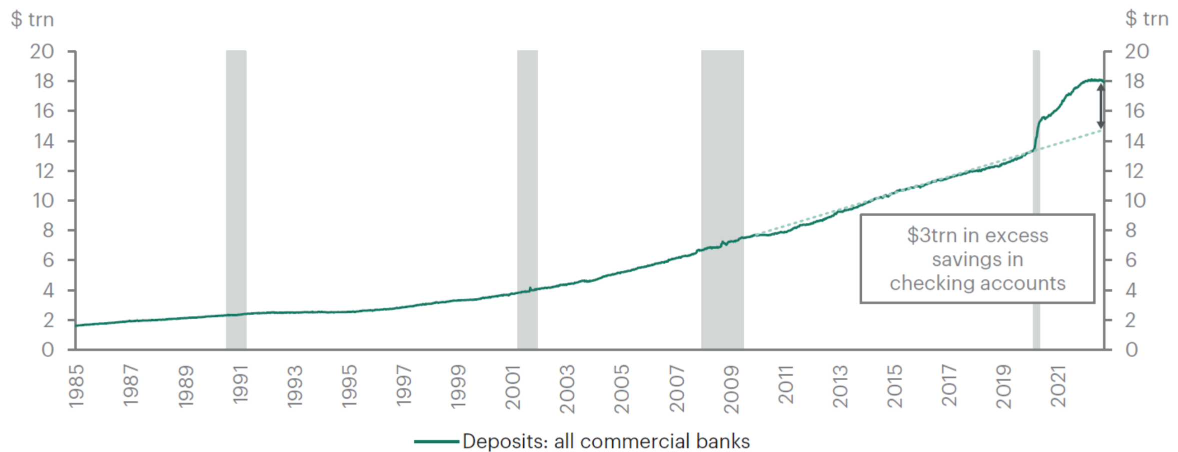
Fig 4: Labour Market Tightness Unwinding with Declining Job Openings



Source: Goldman Sachs Investment Research; Linkup Survey; Indeed Survey.

Fig 5: US Commercial Bank Deposits



Source: US Federal Reserve

- **What of Equity Valuation Multiples and Earnings?**
    - We believe it is possible for the Fed to engineer a soft landing and while anchoring inflation expectations. History also shows that inflation declines are associated with stock market rallies. However, there are two ways of losing money in equity investing: either the earnings go away or the multiple goes away. The 2022 rout in equities has already had a significant impact on equity valuations (Fig 6). The post-pandemic explosion in Growth stock valuation multiples has evaporated in the 2022 bear market. Value stock multiples

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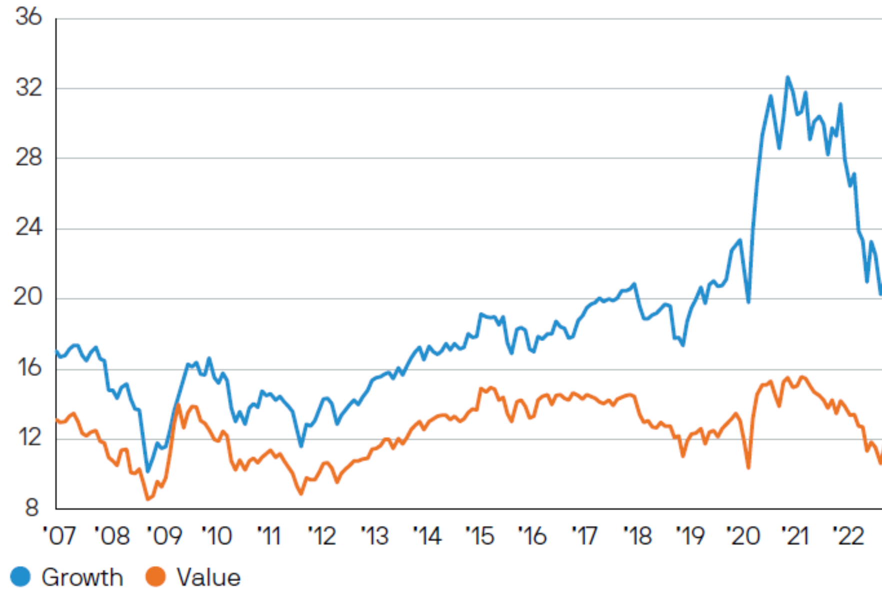
have also declined globally. Generally, valuation multiples are broadly neutral although there are significant variations across regions and sectors.

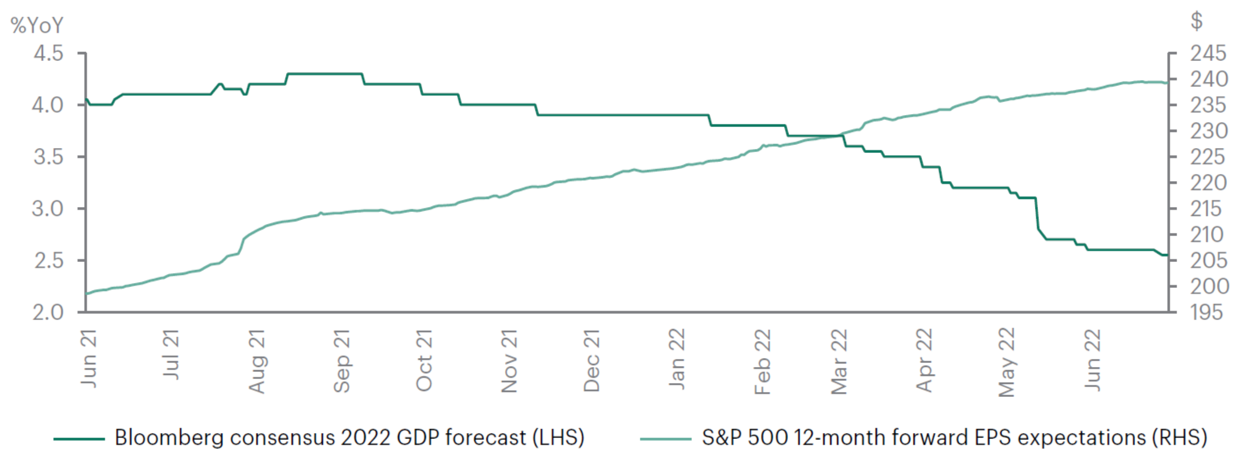
Fig 6: MSCI World 12M Forward PE Ratios: Growth & Value (x)



Source: MSCI; Bloomberg.

The current derating of some stock P/E ratios has reduced, but not completely removed, the multiple risk. However, forward earnings are already expected to rise over the next year and margins are close to record levels. Fig 7 shows a recent disconnect between economic and earnings expectations with the latter not signalling a significant economic slowdown, let alone a serious recession. Whether this earnings optimism is justified or not is a key theme for us to monitor carefully in the coming months. As we move into the Q1 earnings season, expect heightened volatility as this theme plays out.

Fig 7: Some Disconnect between US Economic and Earnings Expectations



Source: Bloomberg.

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- **Summary - Uncertainty creates opportunity**

  - The pandemic, unprecedented monetary intervention and the war in Ukraine has generated huge uncertainty for investors. As active investors, we are looking to turn uncertainty into opportunity. Selectivity in asset selection, valuations and entry points will be paramount in 2023.

  - How will the Fed tame inflation with regard for its mandate to maintain full employment? Although rates will remain elevated due to high inflation levels, we will be looking for the Fed to pivot this year which will be bullish for asset prices. Capital markets do, however, remain vulnerable to valuation risk and volatility is likely to persist through the year. Strategies that can harvest a premium for volatility are likely to outperform this year.

  - The 2022 rout in equity markets has generated opportunities but general market bottoms typically occur only after earnings estimates have been cut. Therefore, investment strategies need to be opportunistic and nimble to maximise returns in 2023.

  - Events of the past 12 months have also created an attractive entry point for emerging markets equities. Valuations have fallen dramatically, even for companies with high profits. And the recent easing of COVID-19 restrictions in China has raised the possibility of higher growth in China over 2023, which, combined with a weaker USD, could create the kind of stable, positive global growth that has led to outperformance for emerging markets equities in the past.

  - General market growth and multiple expansion-based strategies are unlikely to work well this year. Turbulent markets require active strategies such as thematic macro and stock-picking with discipline on purchase price and a focus on operational improvement and free cashflow generation to create value for investors.

  - Sectoral leadership is very important and something we continue to monitor carefully. Financials, industrials and materials have all outperformed in October and November. This profile of leadership is generally not consistent with a hard-landing stagflationary scenario.

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