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Global Asset Allocation Viewpoints

Navigating increasingly unstable markets

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Key themes for 2Q 2023

- **Global economic growth has surprised to the upside, but U.S. recession risk is rising.** Although U.S. growth has remained strong, even accelerating in early 1Q, leading indicators continue to signal recession. Tighter lending standards, as a result of the recent banking crisis, only increase the risk of a hard landing.
- **Price pressures remain too elevated; in most economies, inflation will end the year above target.** Part of the inflation basket will soften rapidly in response to normalizing supply chains and energy prices, but other key segments still require considerable weakening in labor markets if there is any hope of approaching target.
- **Central banks are nearing the end of their tightening cycles as financial stability risks increase.** Each additional interest rate hike increases the risk of further market turmoil. Central bank policy rates will likely peak soon, but rate cuts are unlikely unless there is a severe and dangerous spike in financial system stress.
- **Although equities have been resilient, earnings weakness will threaten further drawdown.** While 2022 dynamics were driven by inflation and rates scares, 2023 is likely to be dominated by earnings and economic growth scares. Margin pressures will weigh on company profitability, leading equities lower.
- **High-quality fixed income offers stability and income in this challenging economic backdrop.** Central banks are likely nearing the completion of their tightening cycle, implying that bonds will be able to support portfolios both as recession approaches and during forthcoming periods of volatility and risk.
- **Alternatives provide important diversification against traditional equities and fixed income.** While inflation is decelerating, it remains uncomfortably high, so portfolios still require allocations to real assets to mitigate inflation risks. Assets that perform well in elevated volatility environments should also be prized.

Investment themes

Price stability vs. financial stability

Lower returns, elevated volatility

Diversification

Entrenched inflation

Price stability vs. financial stability

The recent U.S. banking failures and collapse of a major European bank have finally underscored the tensions between central banks' efforts to tame inflation and growing concerns that further policy tightening will spark a crisis. With inflation still elevated, but markets increasingly alert to the vulnerabilities within the financial system, central banks face a difficult balancing act—continue to target price stability or focus on maintaining financial stability?

The risk of central bank driven financial stress, resulting in bank deposit outflows, rising bank funding costs, and sharp retrenching of lending has raised the odds of a hard landing. Yet, if financial stress fears prompt central banks to end their tightening cycles prematurely, there will be higher risk of an inflation resurgence and even more aggressive rate hikes later down the line, also raising the odds of a hard landing.

Ultimately, financial conditions will tighten further—either via additional central bank tightening as they try to tame inflation, or via tightening credit conditions.

Lower returns, elevated volatility

The reversal in ultra-loose global central bank policy has led to an almost unrecognizable global investment landscape. Unlike the golden era of the past decade where low inflation and low interest rates were suppressing volatility and lifting asset prices, the higher interest rate environment is now uncovering market strains and raising volatility.

Investor behavior will need to adjust: Expectations for returns need to be lowered and expectations for volatility need to be raised. Portfolios need to reallocate risk to both take advantage of market inefficiencies and to minimize exposure to macro-driven threats.

Diversification and quality

Unlike 2022, where stocks and bonds fell together, opportunities are already proving more forthcoming in 2023. While tightening in financial conditions and the likely resulting U.S. recession will weigh on the broad equity market outlook, the relatively attractive valuations outside the U.S. suggest investors stand to gain through global diversification.

Fixed income's diversification potential has also been restored. With many central banks nearing the completion of their tightening cycles, bonds will likely be able to support portfolios, providing income and greater stability during periods of volatility and risk.

Finally, with price pressures only easing very slowly, inflation mitigation via real assets remains a key part of the playbook.

Consider the potential risks

Financial instability: The drastic rise in rates risks severe liquidity disruption. Violent, sudden price moves in one market can provoke a vicious loop of margin calls and forced sales of other assets, with unpredictable results. Markets have so far navigated the rate increases and banking crisis without too much disruption, but there is no guarantee that the remainder of 2023 will be as straightforward

Price instability: While the market appears to agree that inflation will fade this year, history suggests that there is a risk the meaningful inflation decline may not materialize. In such an event, after a short pause, the Federal Reserve (Fed) and other central banks may need to resume policy hikes. Not only would that deliver additional headwinds to growth, but also add to financial instability risk.

Equities

Reduce risk appetite and focus on U.S. large-cap and quality factor.

Position toward certainty:

- Exposure to quality within equities can potentially offer risk mitigation during pullbacks.
- Attractive international valuations suggest opportunities outside the U.S.
- U.S. large-cap offers the potential for stronger downside protection as recession risks loom and the broader economy slows.

How to implement:

- Large-cap U.S. strategies
- Quality-biased active managers
- Well-diversified and active international managers

Fixed income

Increase exposure to high-quality credit.

Core fixed income and preferred securities:

- Core fixed income to hide out in as recession risk rises.
- Recommend increasing duration bias across the asset class.
- Preferred securities provide potential yield and exposure to high-quality.

How to implement:

- IG credit heavy core fixed income for stability
- Preferred securities strategies

Alternatives

Pursue less correlated real asset exposures.

Real assets:

- Real return-focused strategies gain attractiveness when nominal growth slows.
- Infrastructure offers more stable cash flows with potentially attractive yield.
- Real assets can help mitigate inflation risk.

How to implement:

- Diversified real asset strategies (Infrastructure, natural resources)
- Private real estate markets

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. Non-investment grade securities offer a potentially higher yield but carry a greater degree of risk. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Emerging market debt may be subject to heightened default and liquidity risk. Risk is magnified in emerging markets, which may lack established legal, political, business, or social structures to support securities markets. Small and mid-cap stocks may have additional risks including greater price volatility. Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to help investors from a decline in the purchasing power of their money. As inflation rises, rather than their yield increasing, TIPS instead adjust in price (principal amount) in order to maintain their real value. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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