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3Q 2023

Global Asset Allocation Viewpoints

Time is running out

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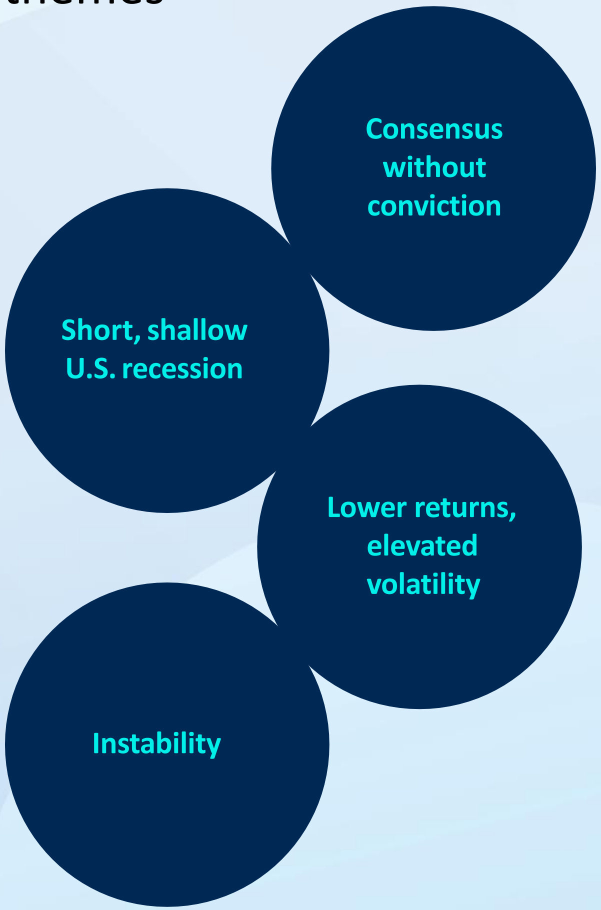
Key themes for 3Q 2023

- **Europe is weakening, China is disappointing, and the U.S. is approaching recession.** While manufacturing has struggled, global growth has been supported by the services sector. Despite resilient U.S. growth, the foundations have been laid for a short and shallow recession later this year.
- **Inflation is decelerating, but at a slow pace, and will end the year meaningfully above target.** Headline inflation is falling rapidly, but core inflation is proving to be a worry in developed markets (DM). Slower economic growth will be required to reach global central bank inflation targets. By contrast, emerging market (EM) inflation has fallen below DM inflation.
- **Most central banks are not done with monetary tightening; rate cuts off the agenda in DM.** Stubborn core inflation has led to a repricing of central bank rate hikes, with further hikes to come in most DM economies, including the Federal Reserve (Fed). Inflation caution also implies that rate cuts will not start in 2023.
- **Equities will come under pressure as earnings weaken and further rate hikes test valuations.** Notably, as a U.S. recession will likely be short and shallow, any equity pullback will likely be short and shallow. The following recovery will likely be reasonably swift, requiring a nimble and active response from investors.
- **High-quality fixed income offers stability and income in this unfolding economic backdrop.** While higher-quality bonds will likely outperform and provide important diversification benefits, the mild recovery implies high yield (HY) defaults may not spike significantly, and elevated HY yields could provide a decent cushion as spreads widen.
- **Alternatives provide important diversification against traditional equities and fixed income.** Inflation is decelerating but remains sticky and elevated, so inflation mitigation via infrastructure remains crucial for investors. By contrast, the slowing growth outlook will further depress commodities and natural resources.

Investment themes



Consensus without conviction

There is currently minimal dispersion in the macroeconomic view amongst investors. A U.S. growth slowdown, an approaching end to Fed tightening, and disinflation are the three almost universally shared expectations connecting most views.

Yet, the continued resilience of the labor market, stickiness of inflation, and gravity-defying gains of artificial intelligence (AI) related stocks have muddied the picture and injected significant uncertainty into the outlook. As a result, investors have limited conviction about near-term market trends and are waiting for clarity about where the economy, rates, and markets will go before taking active positions.

Against an uncertain and confusing macro backdrop, investors would be best served by having a well-diversified broad toolkit among strategies, products, and industries.

Short, shallow U.S. recession

The extent of Fed tightening will likely drive the U.S. into recession. However, this recession—starting in 4Q 2023—will likely be of shorter duration and shallower magnitude than the historical average. Not only are consumers benefitting from the cushion of excess savings, but labor supply is so tight that a cooling of labor demand may not necessarily lead to significant job losses. Furthermore, the health of household and business balance sheets implies that much of the interest rate sensitivity of the economy has diminished.

A short, shallow recession implies that the period ahead will be nothing like the Global Financial Crisis, where asset values were fundamentally impacted for a prolonged time. Instead, a rapid resumption of positive market returns is likely after a correction in valuations to more reasonable levels. Investors should be ready to increase risk asset exposure as the economy approaches its trough.

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 long- term returns need to be lowered, and expectations for volatility need to be raised. Portfolios will need to reallocate risk to take advantage of market inefficiencies and minimize exposure to macro-driven threats.

Consider the potential risks

Financial instability: The drastic rise in rates risks further severe liquidity disruption. Markets have navigated the rate increases and the regional banking crisis without too much disruption, but there is no guarantee that the remainder of 2023 will be as straightforward.

Market melt-up: The AI craze has likely moved too far, too fast. But, without any clear catalyst, mega-cap stocks may continue to rise uninterrupted, pulling up the whole market with them. In this melt-up scenario, valuations would become even more top-heavy, creating a market extremely vulnerable to a significant correction.

Resurgent inflation: If a meaningful decline in core inflation does not materialize, or if inflation starts to rise again, the Fed and other central banks may need to resume aggressive policy tightening. 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 stronger geographical revenue exposure and more attractive valuations.

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.

High-quality, core fixed income:

- Core fixed income to hide out in as recession risk rises.
- Recommend increasing duration bias across the asset class.

How to implement:

- IG credit heavy core fixed income for stability
- Agency MBS 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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