2023 Market Outlook

Mapping another new normal

As we head into 2023, another new normal confronts us. Just as several pandemic-induced changes have become entrenched, inflation is likely to be higher than what it used to be in the decades prior to COVID-19. Consequently, the era of easy money has ended while geopolitical tensions are at a high across the globe. Against this backdrop it is important to be nimble and proactive in one's portfolio choices and positioning.

2022 was a tough year for most investors. 2023 may be even more challenging. Slower growth and tighter financial conditions in the Developed Markets (especially the US and Europe) are clouding the global economic outlook. There is also a growing acceptance that inflation would be more durable than originally thought and that talks of a US Federal Reserve (US Fed) pivot at this point in time are a bit premature.

GROWTH RISKS TO INTENSIFY

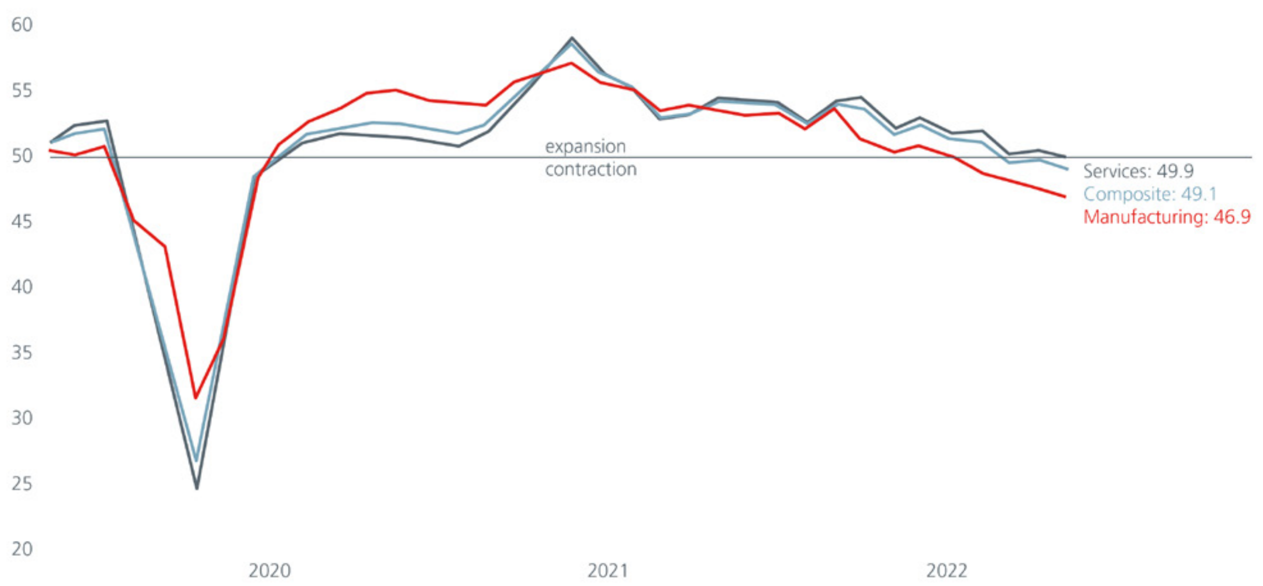
Continued declines in global PMI readings and a broad-based weakening of factory output across regions suggest that the global goods sector is in a recession, prompting comparisons to the 2000-2003 period during which there was a technology-led recession.

Much depends on the inflation trajectory and the consequent impact on monetary policy in Developed Markets (DMs).

While there are signs of inflation peaking, tight US labour markets and strong wage growth may force the US Fed to remain hawkish for longer. Meanwhile, high energy prices which have been another inflation driver will likely face more upward pressure especially as China begins to re-open, and this could prolong central banks' battle against inflation. On the flip side, exogenous factors leading to a decline in commodity prices could bring inflation down rapidly and end the monetary tightening phase earlier than expected.

Nonetheless we believe the current conditions will likely extend into the first quarter of 2023. The US Fed is expected to continue tightening monetary policy into 2023, although the magnitude and frequency will depend on how quickly unemployment rises or how fast consumer prices fall. The median projections from the US Fed currently point to further rate hikes in 2023 before falling in 2024. As it stands, it is likely that the US Fed will only reach its peak of the rate hike cycle mid-2023, barring a tail risk event in financial markets.

Global PMI new orders are falling



Source: Refinitiv Datastream, Eastspring Investments, October 2022.

A better global economy is thus likely to emerge in the second half of 2023 as we navigate past peak inflation and US Fed hawkishness. Any impending US recession will probably be a mild one relative to previous recessions given that the US consumer balance sheets are much more resilient today (even compared to the 2008 Global Financial Crisis).

We acknowledge that equities have more room to decline in a recession, especially as US equities represent approximately 63% of global equities and given the large technology representation in key market cap indices. The extent is however contingent on the magnitude of the recession (i.e., the deeper the recession, the larger the equity drawdowns). That said, further easing of financial conditions on the back of the US dollar peaking will lead to better performance returns for risk assets in the second half of 2023.

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EMERGING ECONOMIES RELATIVELY RESILIENT

Central banks in Emerging Markets (EMs) have also tightened monetary policy, but generally not to the magnitude and pace seen in DMs. This is because for many emerging economies, domestic demand is typically weaker, wage growth is less robust, and hence inflation dynamics are relatively weaker compared to the US. This can be seen in China, which is experiencing weak domestic demand and weak inflation dynamics, primarily due to COVID restrictions and a weak housing market, among other factors.

Over in Asia, inflation has also been relatively benign partly due to the smaller fiscal stimulus response to the pandemic (unlike the US), less exposure to the energy shocks (unlike Europe), as well as more government subsidies, some of which have been passed onto consumers. Meanwhile Asian central banks have been trying to manage their interest rate differentials to contain currency depreciation and imported inflation. While Asian yields were pressured higher in tandem with higher core DM rates, markets struggled to price in much more tightening from Asian central banks amid a weakening economic backdrop and less sticky inflation.

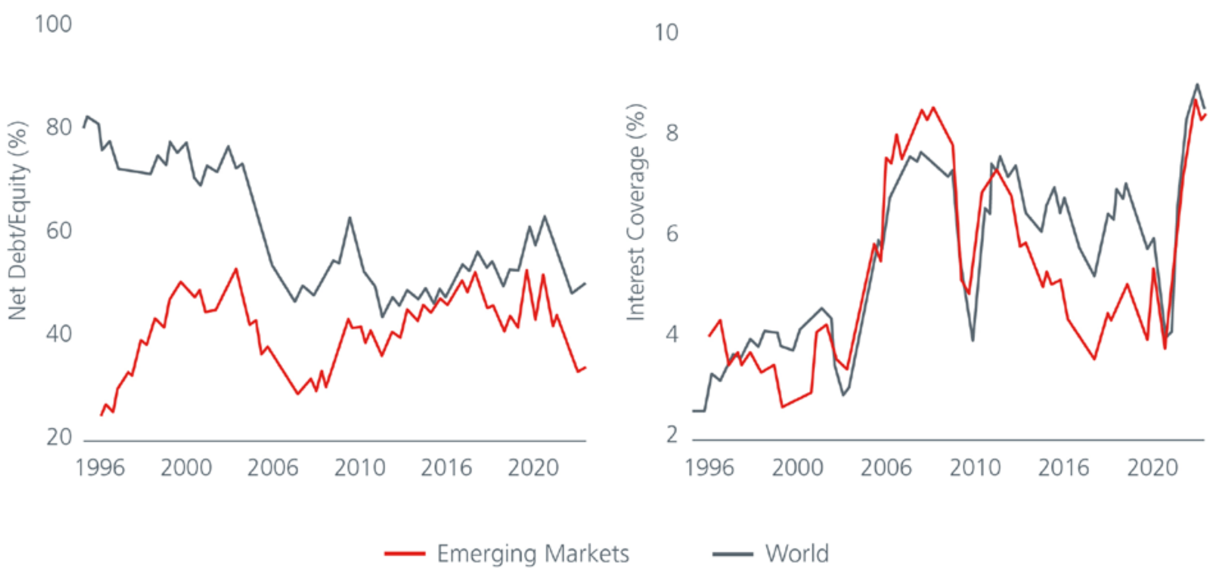
All said, the 2020s have also begun in a very different fashion to the 2010s for EM equities. The 2010s was the perfect backdrop for growth and quality investing as investors were encouraged and rewarded to pay high prices for potential future earnings stability and growth, especially in the e-commerce space. In the early 2020s however, we have seen policy responses to COVID-induced slowdown more focused on investing in the real economy with capital expenditure plans returning and decarbonisation efforts front of mind. Following a volatile year for EMs, we are ending 2022 with a very attractive valuation entry point on a historical context both in absolute terms, but also relative to DMs.

OUR RISK CONSIDERATIONS

We believe the current market environment is quite challenging amid increasing tail risk events and geopolitical tensions (i.e., US-China, Russia-Ukraine, China-Taiwan, Iran nuclear talks). Geopolitical risk is notoriously hard to assess because it is dependent on the unpredictable behaviour of its actors. The Russia-Ukraine conflict in 2022 is perhaps a reminder to investors that following a decade of relatively peaceful geopolitical environment, we may be ushering in a new period of skirmishes caused by rivalry between great powers.

Tighter liquidity conditions and higher borrowing costs are other key risks. As interest rates go up, companies that are not producing reliable profit streams will be most affected and vulnerable. US growth and tech stocks are quite susceptible to deteriorating valuations, and as such have seen some de-rating amid rising rates. Only companies that can produce an economic return from their borrowings are going to be creditworthy institutions.

EM non-financial corporate balance sheets are seemingly healthy



Source: Refinitiv Datastream, Eastspring Investments, October 2022.

Finally, there is a good chance that the US Fed may push the US economy into a recession if inflation persists. Investors need to remain very vigilant to that potential outcome. The US dollar which has strengthened considerably amid rising rates and souring global risk sentiment will likely remain strong in the near term. Emerging and Asian economies may be forced to intervene to reduce the volatility of their currencies. Rapid reserve drawdowns could increase uncertainty.

Ultimately if the US Fed stamps out inflation by crushing aggregate demand, then we are going to see higher unemployment and slower growth, and investors will likely favour fixed income solutions. On the other hand, if more supply-side measures help to ease inflation, then equities are likely to be in demand. In our view, it is very unlikely that inflation is going to be addressed through supply-side measures alone.

Investment implications

Scenarios	Rationale	Equities	Bonds
US Fed continues to raise rates to stamp out inflation which in turn crushes demand, and recession risks grow	Investors typically flock to safe haven assets during these periods.		✓ Long duration Treasuries
US Fed rates peak in mid-2023 as inflation falls due to supply-side measures, and US growth bottoms	Sentiment will turn positive and in a risk-on mode, stocks and credits tend to outperform.	✓ Asia ✓ Emerging Markets	✓ Asian high yield ✓ Asian investment grade
High real interest rates force investors to refocus on company profitability and free cashflows	This is supportive of value stocks which have been under-invested in and mispriced over the past decade.	✓ Value	

Source: Eastspring Investments. November 2022.

invested in bringing you to the forefront of Asia.

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