TALKING HEADS PODCAST

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ASSET ALLOCATION AND THE OUTLOOK FOR 2023

Daniel Marris: Hello. I'm Daniel Morris, chief market strategist. And I'm joined by Maya Bhandari, global head of multi asset. To share with you our 2023 investment outlook, the global economy seems on an inevitable march towards recession.

The causes are well known central banks aggressively raising policy rates to reduce inflation and energy shock in Europe and zero COVID policies, and a shaky property market in China.

Much of Europe is already in recession and we expect one to begin in the US in the second half of 2023. China's growth will likely not turn negative, but it will be below historic levels. One can easily think of ways in which the situation could yet worsen. A breakdown in a key financial market due to the rapid rise in interest rates, a cold winter and blackouts in Europe, or a flare up in geopolitical tensions.

The key variable is inflation. If it slows, central banks will be able to take their foot off the monetary policy break and risk assets will likely recover. On the other hand, if we see more upside inflation surprises, as frankly we did for most of 2022, rates will likely need to climb even higher. Needless to say, Maya, it's been a challenging year and in 2022, what are the key issues you have in mind as we go into 2023?

Maya Bhandari: Well, Dan, there are usually just a handful of key judgments upon which one's investment views ultimately rest. And today, I would say there are probably three particular questions that matter enormously for return prospects in 2023. The first is when? When will the US Federal Reserve and other major central banks because of pivot in their hiking of interest rates?

The second key question is how deep will the growth and earnings correction ultimately be? And the third, and frankly, the biggest unknown is how great will the geopolitical disruption be from China, Russia, the US and Europe in 2023?

Daniel Morris: Let's start with the outlook for rates. Central banks have emphasized the decisions. Follow the data. We've seen that very clearly recently with better than expected inflation data leading to lower expectations for policy rates. How do you see things evolving?

Maya Bhandari: Well, 2022 has been all about slowing real growth, particularly as hawkish central banks delivered really a series of discount rate shocks. Thanks to inflation, though, growth actually rose in nominal terms, even if it didn't feel like it. Now 2023, will to our minds look quite different. We will very likely see slowing nominal growth with both lower real growth and lower inflation.

And this is as expected, of course, because monetary policy actions over the last 12 months will impact the real economy with the normal time lag. And we see this already done and some of the forward looking data for both growth and inflation. And because of this and frankly, as policy rates are already at fairly restrictive levels, we believe that the odds of a quicker, sharper policy pivot to a slower pace of hikes or even opposed are mounting and are mounting prospectively, quite fast.

The balance of risks, if you will, have clearly shifted and policy will need to turn to be more forward looking. Once again.

Daniel Morris: As you said, 2023 is likely to look very different and asset allocations will need to reflect that. So how are you positioned in portfolios?

Maya Bhandari: Well, first, I think it's fair to say we are certainly more cautious on what the environment I just described means for earnings or equity cash flows. And that leads us away from investing at least outright in assets lower down the capital structure, especially equities, but also higher yielding corporate bonds. I think it's really interesting that expectations, earnings expectations that is in more challenged areas such as Europe have actually barely adjusted lower.

And for us going into 2023, equities are really all about relative value. So we went long the US recently and we say long of China and really balance this out with a short two words Europe. Second, and by contrast to what I just noted on European equities, higher quality European corporate credit spreads are still at fairly distressed valuations.

We're not far from 2020 crisis levels for the best rated European corporates. We, from our perspective, this is a remains a valuation opportunity and is our biggest risk position in portfolios today. And lastly, and I think importantly, given that it has been a core high conviction position for us all year, we are no longer short as sovereign bonds, but rather neutral to slightly long duration against those credit views.

I just described risk reward from being cautious on sovereign bonds, it just makes a whole lot less sense to us. At current valuations, 3.8 to 4%. For example, on the US ten year when we were at 175 to 2%, we were deepening our shorts. Risk reward at these levels is just a whole lot less clear.

Daniel Morris: And lastly, geopolitics we all appreciate. It is unpredictable by nature, but certainly cannot be ignored. How do you manage those threats at the same time you need to take risk.

Maya Bhandari: Well, geopolitical risks pepper the investment horizon, and I think is something we will all have to monitor closely in 2023. You know, the evolution of the Ukraine war and the energy crisis, China's approach to Taiwan and the reopening of its economy, trade wars and the impact on supply chains. Each of these developments could and indeed already has altered the path of both cash flows and discount rates.
And these are the two things that ultimately determine the returns we can achieve across asset classes. I would say risks here, frankly, likely to remain elevated throughout the investment horizon of 2023.

Daniel Morris: Thank you very much, Maya.

Maya Bhandari: My pleasure.

Daniel Morris: Well, that's all from us for this year's investment outlook. We live in an age of transformation, and we hope you will join us on the journey to find the opportunities that provides.