

Global Investment Outlook 2023

February 2023



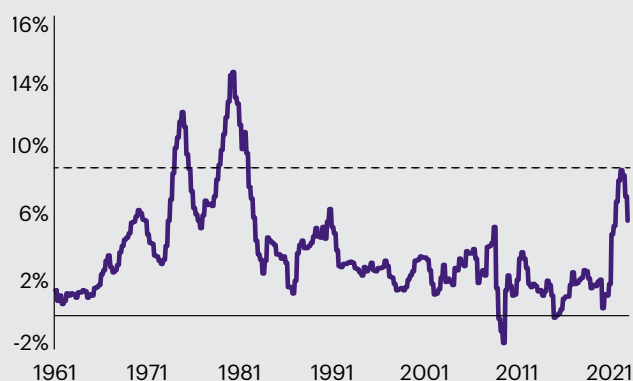
Economies are out of balance

Our key observation is that economies are out of balance — the medium and long-term pathway by which balance is restored is the major question investors must grapple with.

The fundamental cyclical outcome of this imbalance continues to be inflation, which, outside of Asia, remains too high and sticky for central bankers' comfort. How and when inflation is restored to levels acceptable to central bankers is the key near-term puzzle investors must decipher.

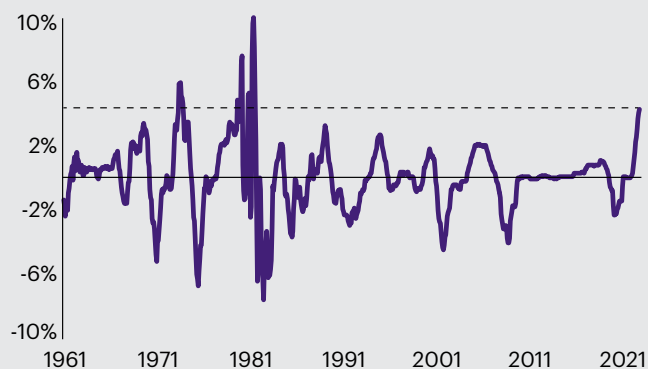
Our view is that the pathway back to balance is more likely to be volatile than smooth. Asset market pricing implies a rapid fall in inflation towards central bank targets, providing space for cuts in policy rates, and facilitating only a moderate slowdown in economic and corporate earnings growth. This outcome is possible and internally coherent but, to us, does not look like the most likely pathway. We think this benign scenario, underlying current market pricing understates the potential for sticky inflation, higher than expected interest rates, and/or lower than expected growth.

Figure 1. US headline CPI inflation — Year-over-year



Source: Refinitiv Eikon, WTW

Figure 2. Rolling 12-month change in the US Federal Funds Rate



Source: Refinitiv Eikon, WTW

Figure 3. The nature of the inflation imbalance differs by country

| | US | Eurozone | UK | China |
|---------------------------------------------------------------------------------------------------------------------------------------------|----|----------|----|-------|
| Tight labour markets (high vacancies vs. unemployment, high wage growth) | ■ | ■ | ■ | ■ |
| Firms with pricing power (firms maintaining profit margins, widespread dispersion of price increases across CPI basket) | ■ | ? | ■ | ■ |
| Energy price shock (high wholesale energy prices, limited/temporary government support) | ■ | ■ | ■ | ■ |
| High and increasing inflation expectations (bond breakevens and/or surveys of consumers) | ■ | ■ | ■ | ■ |
| Weak/fragile currency (current account deficit, high government deficits, procyclical currency, high import weight in CPI basket) | ■ | ■ | ■ | ■ |
| Low investment/productivity growth | ■ | ■ | ■ | ■ |

■ Inflation driver very clearly present and a key influence on monetary policy
■ Inflation driver present and an influence on monetary policy
■ Inflation driver not present and unlikely to be an important influence on monetary policy

Since the key metric of cyclical demand and supply imbalances is inflation, it is useful to consider what the drivers of inflation are and how they differ by country.

U.S.

High US inflation is being driven by resilient spending growth and a labour demand/supply imbalance which is putting upward pressure on wages. The Federal Reserve’s task is clear: slow the demand for labour, restore balance to the labour market and inflation will subside. However, the level of interest rates required to affect that cooling is unknown. Perhaps the Federal Reserve has done “just enough” and inflation will subside smoothly with reasonable growth rates. Perhaps it has already done too much and overtightened monetary policy, with the recent slowdown in growth building momentum towards a recession. Perhaps inflation will be sticky and higher interest rate increases are required despite the implications for growth. We are unsure, we believe the Federal reserve is unsure, but we observe markets are pricing in the optimistic “just enough” scenario.

Europe

In Europe, energy markets have been a prominent driver of rising prices but inflationary pressures are becoming more widespread. The concern is the scale of the energy price shock will be enough to cause second-order impacts on prices outside energy markets, as businesses, consumers, and workers get used to higher inflation and adjust their price and wage-setting accordingly.

The UK faces an unpleasant combination of a US-style tight labour market and a Eurozone-style energy price shock. It also suffers from a fragile currency, high levels of debt owed to foreigners, and a chronically low productivity growth rate, which constrains the ability of the supply side to meet strong demand.

The Bank of England faces a more difficult trade-off between growth and inflation, and an economy more sensitive to interest rates and energy prices. This is very difficult to navigate and the risks of policy error — either not bringing inflation down quickly enough or hitting growth too hard — are high.

China

China has few inflation problems. The nature of its inflection point is the response of the economy to the unwinding of its zero-COVID policy. The easing of health-related policies means aggregate demand should recover strongly in 2023, albeit after an initial negative economic impact associated with high COVID rates. There also appears to be a greater focus from policymakers on securing higher growth in 2023. While this would benefit global demand, it may also increase the total demand for commodities and other goods, adding to inflationary pressures in advanced economies.

The challenge of imbalances is not only a current cyclical phenomenon. The decade leading up to the pandemic was characterised by hyper-accommodative central banks, powerful disinflationary forces — globalisation, technology, high indebtedness to name a few — and declining bond yields. This created a favourable environment for asset valuations, risk premia, and listed company profit margins. It also created an environment of relatively low macro volatility, all of which combined to drive an extremely supportive decade for “simple” equity/bond portfolios. Our observation is that at least some of the factors that delivered this decade have subsided. This means that the 2020s may more closely resemble 2022, with its volatility, challenging beta environment, and shifting correlations than the (with the benefit of hindsight) smooth sailing of the 2010s.

So what does this mean?

Economies are out of balance and the path back to balance is likely to be volatile — what does that mean for portfolio strategy and allocating capital?

We think the three key responses are: diversification (i.e., building portfolios with exposure to a wider range of risk premia), adding downside risk hedging strategies at appropriate pricing, and seeking alpha.



Diversification

Except for 2022 and 2008, a combined equity/bond portfolio has provided consistently strong returns over the last 20 or so years. This was driven by low macro volatility and structurally declining interest rates. We think the coming years and decade are likely to be different, therefore, higher levels of diversification are more desirable. To be sure, our belief is that maximum diversity is always the best idea — so if you're thinking “they always say that” we agree with you! However, we also believe that, right now, macro conditions enhance our conviction in diversity.



Downside risk hedging strategies

The greater level of macro volatility increases the value of tail risk hedges. These should be added to portfolios at appropriate prices and using appropriate instruments. Effective downside hedging, in our experience, inevitably involves dynamism, which we acknowledge creates governance challenges for some but those are surmountable.



Opportunities for alpha

The past decade of low macro volatility has, from time to time, presented a challenging period for skilled investors to add value. An increase in macro volatility and dispersion typically leads to high return differentiation across and within asset classes. In these conditions the value of skilled active management is outsized — our track record shows it can be found.

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