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4Q outlook: Discovering resilience

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CIO Global Wealth Management provides objective investment research and guidance to help you pursue your investment goals. Here is a brief overview of an important new report. Take a look and if you have any questions, please call.

After a challenging first half of 2022, the third quarter was characterized by volatility, with hopes and fears about inflation and Federal Reserve policy, the energy crisis in Europe, and China's twin COVID and real estate challenges the most prominent market drivers.

At the time of writing, global equities (MSCI All Country World Index) are 22% lower year-to-date. The Bloomberg Global Aggregate Total Return Index of government and investment grade corporate bonds has fallen more than 20% from its 2021 peak, the biggest drawdown since its inception in 1990. Similar volatility has been evident in the US dollar, which has rallied to 20-year highs.

In the *Year Ahead outlook* from our Chief Investment Office for Global Wealth Management *(CIO)*, "A Year of Discovery," published in November 2021, CIO said that the process of discovery of a new balance between supply and demand across multiple markets would create uncertainty that investors would need to navigate. More than 10 months on, that process continues to create volatility and uncertainty. The Fed is likely to require more evidence that inflation is firmly under control and the US labor market is cooling before it eases off on interest rate hikes. With Russia cutting off some of its gas supplies to Europe, the region faces an unwelcome combination of high inflation and negative growth. And China's recovery continues to stutter, with its zero-COVID policy and real estate challenges complicating the economic picture.

At the same time, there are some reasons to be hopeful, particularly for investors with longer-term time horizons. The US labor market remains strong, mitigating fears of a near-term recession. Inflation expectations have fallen, suggesting that conviction remains high that prices will come under control. Significantly, too, for investors looking to allocate for the longer term, valuations across equities and bonds are much more favorable now than they were as we entered 2022. CIO's base case is that equity markets will take a bumpy road higher by June 2023.

On balance, CIO thinks this is an environment to be invested and diversified, but also be selective. This is not an environment to be positioned too heavily for any given short-term scenario, but it is one in which CIO believes smart reallocations within asset classes can improve the risk-return profile of overall portfolios to become more resilient. Five broad themes characterize CIO's market preferences: **defensives, income, value, diversity,** and **security**.

First, to manage portfolio risks, CIO thinks investors should tilt toward relatively **defensive** parts of each asset class. Within equities, this means boosting allocations to healthcare and consumer staples, relative to consumer discretionary. Within fixed income, CIO prefers high-quality bonds and resilient credits, whereas they are more cautious on the outlook for cyclical credit and pockets of high yield. And within currencies, CIO continues to expect appreciation for the US dollar and see the Swiss franc, another safe haven, as their preferred currencies. Investors can also consider capital protection strategies.

Second, to maintain a steady flow of capital amid uncertainty, CIO advises investors to seek **income** opportunities across asset classes including quality income stocks, select short-duration bonds, and direct real estate and lending. Investors can also consider volatility-selling opportunities in foreign exchange and commodities to improve portfolio yields.

Please see important disclosures on reverse.

Third, CIO continues to believe this environment of elevated uncertainty and rising interest rates will favor **value** stocks—those with relatively low valuations backed by proven near-term profits—rather than more highly valued growth stocks that are more reliant on future earnings projections. The UK market has a relatively high concentration of value sectors, and CIO also continues to like global energy stocks—another value sector—which should be further supported if tight commodity supplies lead to higher prices, as CIO expects.

Fourth, with equity and bond markets both still heavily driven by central bank policy expectations, CIO thinks investors should **diversify** into alternatives, including hedge funds and private markets, to diversify portfolio correlations and mitigate volatility. Within hedge funds, CIO prefers discretionary macro, fixed income relative value, and low net equity long/short strategies, as well as multi-strategy funds, all of which should be well suited to navigating volatile and range-bound markets. CIO also recommends finding value in private markets in secondaries, distressed/restructuring debt, and value-oriented buyouts.

Finally, while CIO retains a least preferred stance on growth stocks, the era of **security** and the global transition toward stability and sustainability continue to generate attractive long-term opportunities, in CIO's view.

Stocks
In CIO's base case, they expect stocks to move higher by next June, with volatility along the way. CIO's forecasts for falling inflation, lower bond yields, and positive earnings growth (even if slow) are consistent with higher equity prices. Given the uncertainty, CIO recommends defensive positioning within equity sectors, as well as a focus on income and value stocks.

Inflation
Inflation has continued to surprise to the upside, though CIO expects it to slow in the US in the months ahead. Lower gasoline prices are providing relief, and with consumer spending shifting away from goods, the supply side of the economy is catching up with demand. Service prices remain a key variable to watch, with stronger consumer demand, tight labor markets, and rapid wage growth putting more persistent-than-expected upward pressure on prices. Inflation in Europe is not likely to peak until later in the year, or in early 2023, and the impact of higher energy prices is likely to be most strongly felt in the winter.

The Fed
Upward surprises to inflation data mean that the market has adapted to the idea that the Fed will need to hike rates faster and further than had been expected earlier in the year. As of this writing, the projected federal funds rate now suggests a peak at 4.6% in May 2023.

In CIO's view, it is likely that the Fed will hike rates at each of the remaining FOMC meetings in 2022. And if inflation stays high for longer than CIO expects, the Fed will be forced to continue hiking rates into 2023, even if that triggers a recession. The Fed will likely want to see at least three consecutive months of low month-over-month inflation slowing and signs that the labor market has cooled sufficiently to ease inflationary pressures before it considers pausing the hiking cycle. But equally, if inflation falls in line with CIO's projections, the Fed could avoid needing to implement additional rate hikes in 2023 and could consider rate cuts by late 2023.

Yields
CIO thinks the 10-year US Treasury yield, at 3.53%, is likely already close to its highs for the cycle (CIO's end-year forecast is 3.5%). If inflation declines, this will likely lead to lower expectations for Fed policy hikes, supporting bonds, while if inflation and rate expectations remain high, this will likely increase the potential severity of any future recession and raise the demand for hedging assets like long-term bonds. CIO expects 10-year yields to fall to 3.25% by June 2023.

Tech
Growth stocks have underperformed the rest of the market (MSCI All Country World Index) by 6 percentage points this year due to a combination of higher inflation, higher rates, and higher real yields. CIO expects this underperformance to continue. The valuation gap between growth and value stocks remains high. Value stocks tend to outperform while inflation is above 3%. CIO also thinks investors may be underestimating some of the potential earnings downgrades in the technology sector. Within growth, CIO sees most opportunity in stocks linked to the era of security, as the world transitions to a greater focus on security, stability, and sustainability, across energy, food, and technology.

Commodities
Commodity prices are below their June highs, with tight supply conditions more than offset by expectations of weakening global demand. In the near term, CIO expects limited OPEC+ spare capacity, the end of OECD strategic oil reserve sales, a ban on EU imports of Russian oil, and substitution demand for oil (given extraordinary gas prices) to support oil prices. CIO also expects the war in Ukraine and weather-related factors to keep grain prices firm. CIO sees around 15% total return upside for broad commodity indexes over the next six months.

The dollar
The US dollar has reached its strongest levels since 2002 versus the euro, and multi-decade highs versus the yen and sterling. It is also up roughly 10% versus the Chinese yuan. This year's appreciation leaves the greenback even more overvalued on a purchasing power parity (PPP) basis, at EUR 0.98 versus EUR 1.36. Although the dollar is exceptionally strong, it is likely to stay that way while the Fed is hiking more aggressively than other major central banks and while the US economy remains relatively resilient. The dollar will also likely benefit if geopolitical tensions worsen, and therefore CIO continues to watch the Biden administration's approach toward China as well as the ongoing war in Ukraine. Given this, CIO moves the currency to most preferred this month and only expect it to start to weaken once the peak in US rates is more clearly in sight.