2023
Global Market Outlook

Navigating a Bumpy Landing

STATE STREET GLOBAL ADVISORS

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Navigating a Bumpy Landing

Across the world, 2022 has been an incredibly challenging year. Global economies are grappling with inflation, central bank tightening, and expectations of lower economic growth — each of which signals caution for investors. Looking to 2023, we expect market uncertainty and volatility to persist for some time, leading to a bumpy journey ahead with a wide range of possible outcomes. We anticipate more clarity will be achieved in 2023 as we see rates peak in much of the developed world, but what follows is anything but clear. 2023 will not be a straight path. Many risks to a sustained recovery remain.

Outlooks

On the Brink of Overtightening

With peak inflation behind us, peak policy rates should follow. The focus shifts back to growth concerns.

Bonds Are Poised for a Turn

The Fed's hawkish rhetoric will likely shift over the next year, opening a window for increased opportunities in fixed income.

Rate Peak Likely to Signal Equities Recovery

A pivot to a sustained upside move in equities is likely in the second half of 2023, but that is dependent on the timing of the US rate-hike cycle reaching its peak.

Macroeconomic

On the Brink of Overtightening

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Across the world, 2022 has been an incredibly challenging year. Global economies are grappling with inflation, central bank tightening, and expectations of lower economic growth — each of which signals caution for investors. Looking to 2023, we expect market uncertainty and volatility to persist for some time, leading to a bumpy journey ahead with a wide range of possible outcomes. We anticipate more clarity will be achieved in 2023 as we see rates peak in much of the developed world, but what follows is anything but clear. 2023 will not be a straight path. Many risks to a sustained recovery remain.

We remain nimble as we brace for an uneven, turbulent journey in the coming months. We expect 2023 to be a time of "Navigating a Bumpy Landing." Amid this market volatility, we continue to be underweight risk assets. We favor quality assets in equity markets and a "barbell" strategy in fixed income, i.e., establishing cash and long-term positions. Caution is warranted given the potential for both persistent inflation and overtightening by central banks, but we expect a better environment for risk-taking to emerge in the second half of the year.

In these challenging times, we are focused on issues that are top of mind for investors. Increased market volatility is causing investors to seek downside protection to strengthen their portfolios for all seasons. A cash cushion provides capital preservation, much needed yield, and dry powder to deploy as the macroeconomic picture brightens. Long bonds, particularly Treasuries and investment grade credit, have backed up to levels that look attractive unless inflation fails to moderate, which is not our core call. And a less strong dollar will provide better risk-adjusted return opportunities for non-US assets. We explore these themes and more in this year's Global Market Outlook.

2023 Outlook

The global economy is rapidly slowing as the current monetary tightening cycle unfolds at top speed, particularly in developed markets. Central bank efforts to tame inflation will inevitably cause some harm in terms of growth and employment, but for now this damage represents an acceptable tradeoff — economies will experience some short-term pain in exchange for long-term gain, and markets will experience some short-term volatility in exchange for long-term stability.

The speed and aggressiveness of these hiking moves concern us, in a world where equilibrium is very hard — perhaps even impossible — to achieve. After all, we are still dealing with the protracted war in Ukraine and its troublesome implications for European energy supplies, as well as with the lingering effects of the pandemic on supply chains, migration, and human behavior. There are plenty of wild gyrations in the current macroeconomic data but no clear indication of where these indicators will ultimately settle. We are therefore reluctant to extrapolate too much from this moment in time.

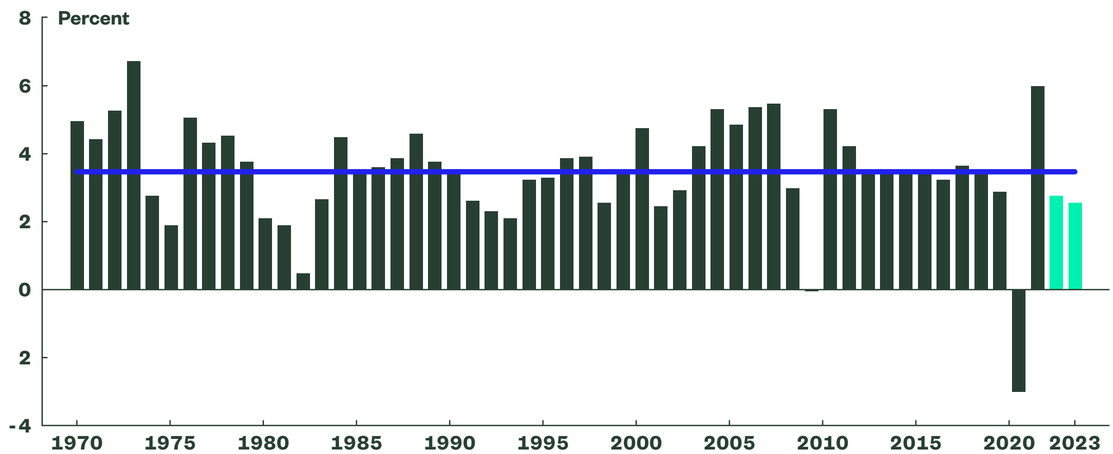
Policy Risk and a Strong Dollar

Against this backdrop, the risks of overtightening seem considerable. While inflation remains unacceptably high at the moment, a whole range of leading inflation indicators — led by oil prices — suggests that a powerful disinflationary episode lies ahead. Evidence that inflation expectations are de-anchoring seems scant. And while the debate about a new, higher global inflation regime is pervasive, the timeline and magnitude of such a potential shift is highly uncertain and, in our view, improbable.

The global economic slowdown has intensified across both developed and developing economies (see Figure 1). Unsurprisingly, we have lowered global growth forecasts, particularly for next year. We now see global growth at just 2.6% in 2023, a number that is half a percentage point less than it was three months ago and meaningfully below trend. Risks remain to the downside. The substantial appreciation of the US dollar year-to-date has intensified global growth challenges and, while it has reversed quite a bit recently, could still expose other, unanticipated vulnerabilities.

Figure 1
Global Slowdown Intensifies

World Real GDP Growth (WEO)
World Real GDP Growth, SSGA Forecast
Long-Term Average Growth (3.5%)



Source: State Street Global Advisors, International Monetary Fund's World Economic Outlook (WEO). Data as of November 4, 2022.

The global macroeconomic and geopolitical environment remains especially challenging for the emerging markets (EM) universe, particularly in economies that are more vulnerable to pricing shocks from energy, food, and raw materials. Coupled with the ongoing monetary policy tightening cycle, the continuing slowdown in global demand, and the current tensions between the US and China, we see a difficult near-term backdrop for EM growth.

A Brighter Horizon

Our core view is that, despite these vulnerabilities, at some point over the next 6–12 months conditions will likely begin to improve. A key signal of such an improvement would be clear evidence that the inflation surge of the past year is beginning to subside. We are optimistic that inflation — in the US and globally — will trend visibly and materially lower within the next six months. This would, in turn, facilitate a reset of expectations with respect to how long policy interest rates need to remain deeply in restrictive territory. As markets adjust to this future dovish shift, the dollar would likely take a bit of a breather, supporting financial stability in emerging economies.

Demand — particularly goods demand — is unlikely to rebound in any meaningful fashion over the course of next year. Goods demand broadly (but especially in the US) first needs to normalize lower to correct for the Covid-induced overshoot. The only notable exception to this downshift is automotive demand, where supply limitations have precluded the rebound in sales seen elsewhere in the goods complex. Commodity demand, however, is likely to remain robust, specifically for energy and foodstuffs. We also see opportunity for replenishment of inventories, supporting prices and export revenues for a wide swath of emerging markets.

Despite the underwhelming demand outlook, we anticipate some moderate improvement in emerging markets growth performance in 2023, driven primarily by an acceleration in China. This, in turn, reflects easier base comparisons following a sub-par 2022 performance, a modest recovery in housing investment, and — most importantly — an easing of domestic Covid-related mobility restrictions.

Finally, 2023 should bring about some improvement in the geopolitical landscape. With key political events (China's Party Congress, US mid-term elections) out of the way, there are compelling reasons for the US and China to seek to scale back their rhetoric. Likewise, though there is no clear off-ramp in the Russia-Ukraine War at the moment, such an opportunity could present itself over the course of next year. The extended duration of the conflict and associated human and economic costs should create incentives for some degree of de-escalation, all of which would help restore confidence.

Macro Takeaways

The global economy is rapidly slowing as the current monetary tightening cycle unfolds, and we are on the brink of overtightening. Against this backdrop and in a challenging geopolitical environment, over the next 6–12 months we expect to see an inflection point, after which conditions should begin to improve. We recognize that a turbulent journey lies ahead with elevated volatility in rates and inflation.

- Global growth will slow into the new year, with US and European growth not much above zero. Risks are to the downside. We expect sub-trend growth into 2024.
- Improved supply and slowing demand allow a powerful disinflationary episode to unfold by mid-2023.
- More favorable inflation data allow the Fed to downshift from its hawkish stance, leading to rate cuts potentially in Q4 2023.
- Peak US rates should lead to a US dollar decline (if global growth dynamics do not deteriorate further).

We do believe that markets will begin to recover in 2023, but we also believe that the pain that investors currently feel may be with us until mid-year, if not longer, with the exact timing of the relief tied to the actions of central bankers. A meaningful lowering of inflation, and some earnings growth visibility, are necessary to enable risk assets to find their bottom. We remain vigilant in looking for conditions and signals to improve. Until then, caution, patience, and agility are warranted.

Fixed Income

Bonds Are Poised for a Turn

Matthew Nest, CFA
Head of Active Global Fixed Income

Fixed income investors will remember 2022 as one of the most trying years, with bond yields rising dramatically year to date translating to some of the worst total returns in decades. Across the board, global yield levels have risen sharply — in both developed and emerging economies. Rising interest rates, market volatility, and widening spreads across sectors have pressured fixed income total returns with an intensity that few experts predicted. Fixed income investors, long accustomed to the diversification, stability, liquidity, income, and total-return attributes of traditional fixed income, have had to reassess their fixed income strategies and embrace a more flexible, tactical, and long-term approach to weather these storms. Investors are eager for a signal that fixed income markets will turn.

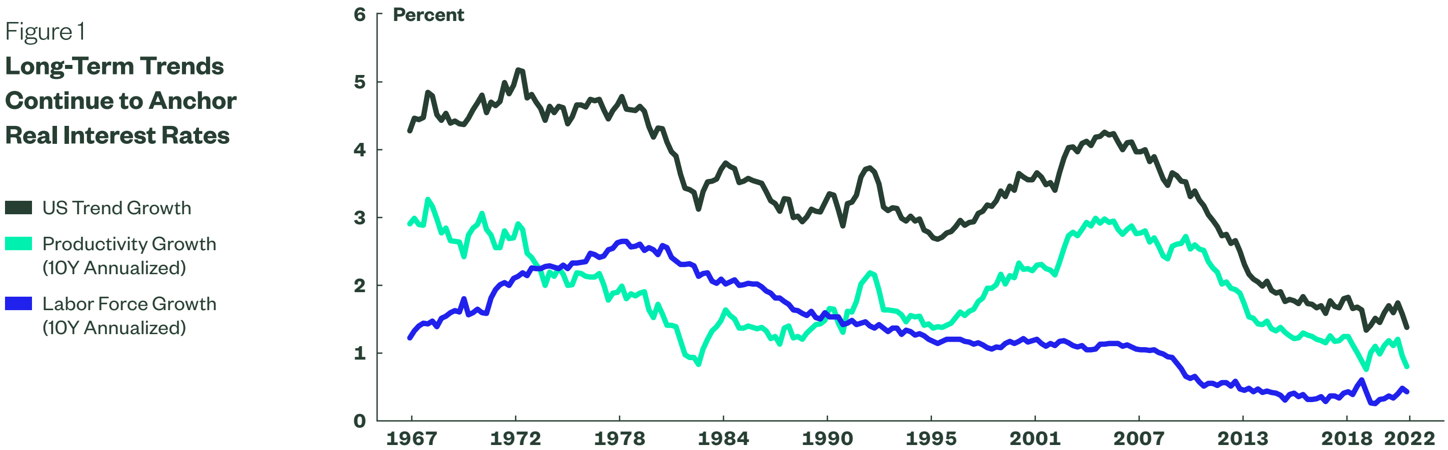
Despite these challenges, we expect conditions to shift in fixed income markets over the next 12–18 months. Amid these challenges we do see bright spots and areas of opportunity for investors. One bright spot is that, although price returns have been painful, investors are notably now getting more income from their fixed income than they have in a long time. Current yield levels in most of the major fixed income sectors are either at 10-year highs or at the higher end of these ranges. Record levels of inflation, triggering central bankers' raising of short-term interest rates, continue to be the main drivers of the bond market's poor performance. As such, yield momentum remains bearish in the short-term.

Keeping Both Hands on the Wheel, with Eyes on the Long-Term

Long-term structural indicators continue to point to a low-growth environment anchored by slow labor force growth and weak productivity growth (see Figure 1). Demographics have been trending downward for several decades and are expected to continue to do so in the developed world. Labor force participation is a major factor driving the picture. An expansion in participation could help offset slowing population growth and aging demographics. However, the participation rate remains below pre-pandemic levels, and if we exclude the recent period since Covid, one would have to go back to 1977 to see a participation rate as low as it is today.

The first quarter of 2022 also saw the largest contraction in productivity — down 7.5% quarter-over-quarter[1] — that we have seen in 75 years, anchoring longer-term trends in productivity. Debt also continues to pile up, further inhibiting a strong growth environment, and governments, businesses, and consumers face increasing interest costs as a percentage of income. While these trends will continue to anchor real economic activity and therefore real interest rates, cyclical developments in growth and inflation will dominate the short-term outlook.

Figure 1
Long-Term Trends Continue to Anchor Real Interest Rates

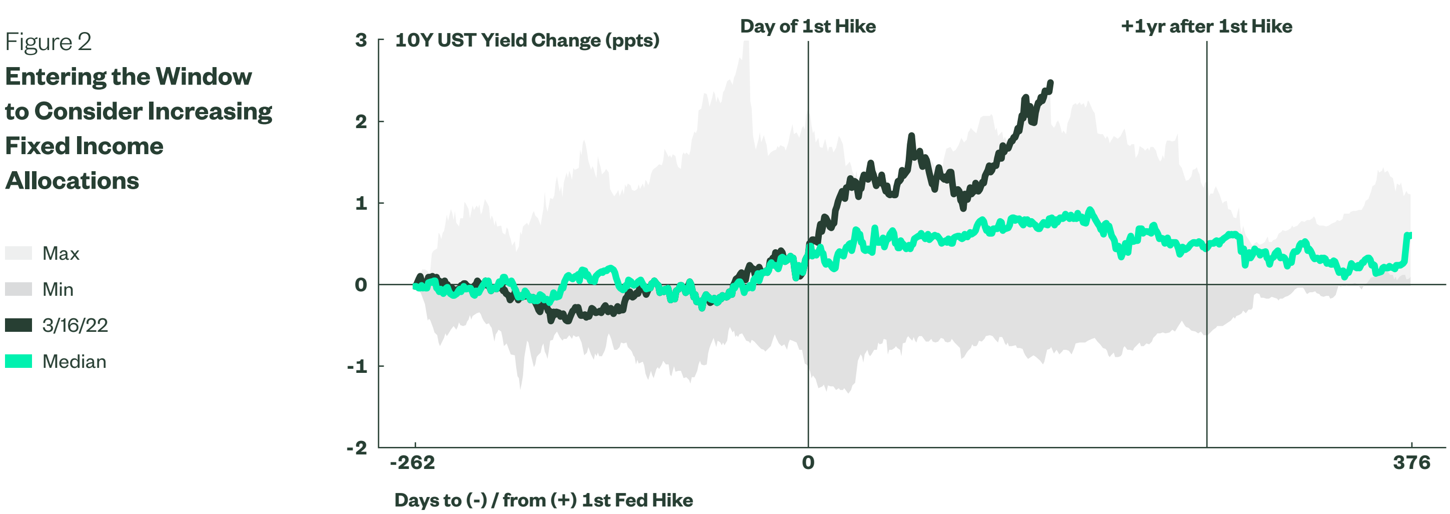


Source: Bloomberg Finance, L.P. Data are quarterly from March 1967 to March 2022. Labor force and productivity growth rates are 10-year annualized numbers; trend growth is the sum of long-term labor force and productivity growth.

Cyclically, growth has been slowing since the summer of 2021, and recession risks are rising. The yield curve[2] is negative. Forward rate expectations are well above underlying economic fundamentals. And central banks, particularly the US Federal Reserve, have indicated they are getting closer to the end of the hiking cycle.

Year-over-year inflation likely peaked in June of this year and will continue to fall over the course of the next 12–18 months. Some relief from upward inflationary pressures should stem from incremental improvements occurring in supply-side pressures, as well as tightening financial conditions that are already dampening economic activity. In order for inflation to remain sustainably at current levels, we would need to see meaningfully higher moves in long-term inflation expectations, which have remained well anchored. The latest University of Michigan survey found that the median respondent projects inflation to rise 2.9% on average over the next 5–10 years. This represents an increase of only approximately 0.4% in long-term expectations over the past 12 months, during which time year-over-year Consumer Price Inflation (CPI) has doubled from 5.4% to 8.2%. In this context, we believe we are entering the window where investors should consider increasing their allocations to fixed income within portfolios (see Figure 2).

Figure 2
Entering the Window to Consider Increasing Fixed Income Allocations



Source: Bloomberg Finance, L.P., Federal Reserve, and State Street Global Advisors analysis, as of September 30, 2022.

Closing Thoughts

We are closely monitoring inflation and the risks of overtightening as the Fed continues its singular focus on fighting inflation. The Fed's hawkish rhetoric will likely shift over the next year. As we see value building in rates, we prefer duration over spread products and investment grade over high yield. We remain cautious on credit and will continue to be so until the clouds of economic uncertainty begin to dissipate. The market's volatility which has contributed to credit spreads widening is likely to present opportunities for discerning credit investors. When more clarity appears on the credit landscape, we think investors should consider global markets, including emerging market debt which has been repriced to levels that may sufficiently pique interest. More tactical investors with shorter time horizons may want to hold off on buying fixed income, given the current bearish rate and spread momentum.

While 2022's macroeconomic and market turmoil has resulted in negative total returns in most fixed income sectors, the widespread sell-off and continued volatility have opened up some attractive opportunities for fixed income investors with longer-term horizons. We remain vigilant and conservative, focused on the long-term view and keeping steady hands at the wheel.

Equities

Rate Peak Likely to Signal Equities Recovery

Gaurav Mallik
Chief Investment Strategist

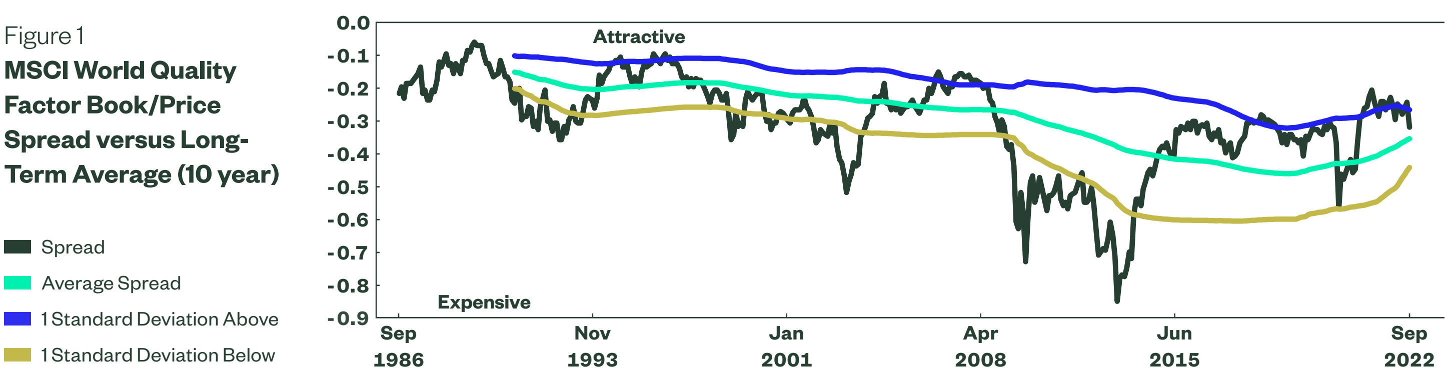
Altaf Kassam, CFA
EMEA Head of Investment Strategy & Research

Having endured a volatile 2022 in which many equity markets have at times fallen by 25% or more from their peaks, equity investors are anxiously looking for signs that a broad market recovery is on the horizon. We do believe that equities will begin to sustainably recover in 2023, but we also believe that the pain that equity investors feel will not begin to lastingly subside until mid-year, with the exact timing of the relief tied to the actions of central bankers.

We are currently underweight equities. That said, at their current levels we do not see a lot of potential downside in equity markets, as we believe that most bad news has already been priced-in. Our base case thinking about the timing of a pivot to a sustained upside move in equities is the second half of 2023, but that is dependent on the timing of the US rate-hike cycle reaching its peak. Thinking positively, if inflation is meaningfully reduced more quickly than central banks expect, then the peak-rate timing (and timing of a pivot) could be advanced. Alternatively and more worrying, peak-rate timing could be advanced if employment or economic growth show serious damage from central bank actions.

Against this backdrop we are focusing on Quality stocks, which remain inexpensive relative to historical norms (see Figure 1). Here we look for firms with stable earnings and strong business models — i.e., those that are resilient enough to pass on price increases to customers. With long-term interest rates unlikely to return to the zero or negative levels of recent years, we are also looking for companies that can withstand rising interest rates and effectively operate with less liquidity than they have in the past. Presently, firms with these characteristics are most prevalent in US equity markets.

Figure 1
MSCI World Quality Factor Book/Price Spread versus Long-Term Average (10 year)



Source: MSCI, FactSet, State Street Global Advisors, as of September 30, 2022.

Given the current extremes in valuation caused by falling markets, we also believe that Value stocks will likely outperform when the pivot comes. As inflation and real yields stabilize, we will look to add to equities from outside of the US — especially Europe — which currently have a stronger Value bias. Looking into 2024 and beyond, we are confident that investment in Eurozone equities will be supported as energy issues are resolved and sentiment improves. Notably, however, the UK's prospects will only improve if the Brexit hangover is treated with a dose of stable government and economic policy, leading the labor market to stabilize.

In emerging markets, we continue to look for signs from China that suggest a stable and clear opportunity for equity investors there. The current weakness of China markets, as well as the strong US dollar, combine to limit equity opportunities in emerging markets.

The equities investing landscape reflects a complex world, so we are also paying close attention to relevant events. A resolution to the Russia-Ukraine War, which is pressuring energy prices and depressing European markets, would be a strong positive catalyst to equity markets, as would clearly constructive economic signals coming out of China. As we write this, neither is evident.

Closing Thoughts

It is a difficult time for equity investors, but challenges always represent opportunities. Investors would do well to be prepared for a market pivot during 2023, and in the meantime we suggest that higher-than-normal volatility can be managed with dynamic asset allocation and/or approaches that include managed volatility and defensive equity strategies. In a time of elevated rates, cash is no longer a drag on a portfolio and provides dry powder for increasing an equity allocation at a prudent time.

We believe that Quality stocks will outperform the broader market, both in the near term and when a rate peak signals an inflection point for equities. Severely depressed equity valuations suggest that Value stocks will outperform as well when sentiment lifts, especially in Europe.

We are keeping an eye on a great many drivers of equity performance, and hope to be in a position to move to a risk-on positioning during 2023. Patience is a virtue that the markets reward.

Investment Themes

Downside Protection: Why It Matters for All Markets

In an environment of heightened market uncertainty and volatility, investors need to consider the portfolio guardrails they have in place to help withstand market disruptions.

Patience Is a Virtue: Finding Opportunities in Fixed Income

Investors should prepare to make shifts in their portfolios as peak policy tightness draws closer — preserving liquidity and exercising patience in identifying entry points.

Keeping a Close Eye on the Dollar

Rising yields and recession risk are likely to abate in 2023, sending the US dollar lower and opening the door for a broad rally in risk assets, particularly non-US equities.

Downside Protection: Why It Matters for All Markets

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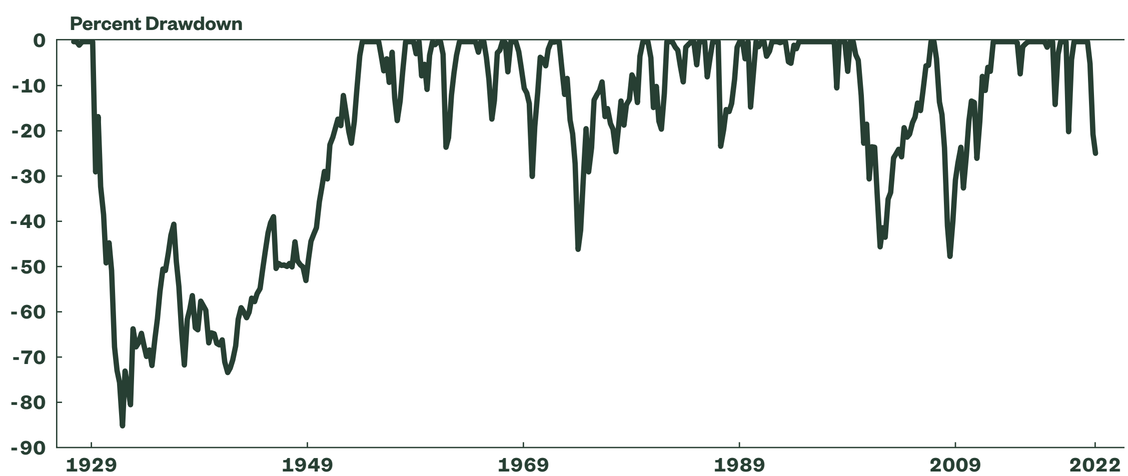
Global Head of Portfolio Strategy, Investment Solutions Group

Even the most prescient investor would have been hard-pressed to predict the path of markets since the start of the pandemic. Recent simultaneous drawdowns in equity and fixed income markets have been all the more surprising because they followed a decade marked by unusually low volatility and remarkably consistent positive returns. We believe that the “Great Moderation” period is clearly over, with central banks less likely to backstop markets as they fight inflation and look to reduce their balance sheets. The “new normal” higher-volatility environment should still provide opportunities for equity investors, but it will also likely feature deeper drawdowns and shallower (less V-shaped) recoveries. Importantly, actively managing the risk of the current environment will require proven downside protection strategies.

Investors should consider downside protection strategies not only during uncertain markets, marked by heightened volatility, but also during all other market cycles. Large drawdowns happen frequently and unexpectedly and can take time to recover from (see Figure 1). Downside protection, we believe, is an effective tool both from an offensive and defensive perspective — one that investors should consider for their portfolios across all market cycles.

Figure 1
Evolution of the Drawdown
S&P 500 Price Return Index, September 1929–September 2022



Source: Bloomberg and State Street Global Advisors. Standard & Poor’s S&P 500 Index is a registered trademark of Standard & Poor’s Financial Services LLC. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

Win by Not Losing

Downside protection is usually seen as a purely defensive positioning — protecting against losses and preserving capital. But it should also be seen as an offensive approach: If investors can limit losses during a significant market drawdown (preserving "dry powder"), they can then re-allocate that capital toward riskier assets after the drawdown, benefiting from rising return premiums. Downside protection's defensive perception has discouraged some institutions from using these strategies, but there are effective approaches that enable investors to stay protected and capture the growth potential of equity investments. Two are detailed below, and we recommend a structured approach to considering, discounting, and eventually choosing between approaches.

Defensive Equities

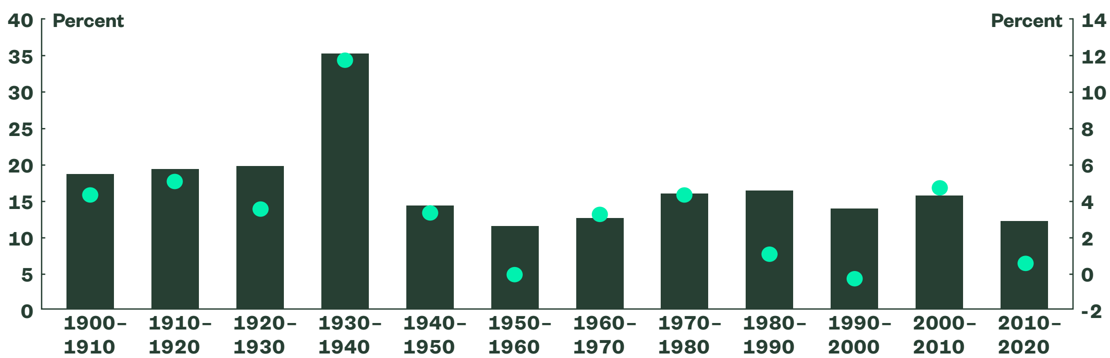
It is important to maintain a long-term perspective on defensive strategies because, for example, market performance since the Global Financial Crisis (GFC) has been consistently positive. One way to gain this perspective is to use the long-term characteristics of an 80:60 defensive equity strategy and proxy its long-term performance against the historical returns of the Dow Jones Industrial Average (DJIA). The 80:60 concept — trying to capture 80% of the market upside and to participate in only 60% of the market downside — has been largely realized in the long-term performance of leading defensive equity strategies.

A review of the performance of the 80:60 concept going back to 1900, by decade, shows that in all but three of the past twelve decades, investing in an 80:60 strategy would have delivered outperformance over the DJIA Index. Furthermore, the level of outperformance has generally been greater in more volatile environments (such as the one we are experiencing).

Figure 2
Excess Returns of an 80:60 Strategy versus the DJIA, by Decade

Annualized Standard Deviation of DJIA (LHS)

Annual Excess Return of 80:60 (RHS)



Source: FactSet, Dow Jones, State Street Global Advisors as of September 30, 2022. The sample 80:60 portfolio returns shown are based on the returns of the underlying market indices in the proportions shown. The returns of the "80:60" strategy were achieved by multiplying positive monthly returns by 80% (0.8) and negative monthly returns by 60% (0.6). Months with performance of 0% remained as such. Past performance is not a reliable indicator of future performance.

This is not surprising, as previous research has shown that, over the long term, strategies with lower volatility objectives have superior returns — generally because investors' behavioral bias toward taking on the riskiest assets drives high volatility (while suppressing long-term returns).

In an up-market cycle, investors get overly optimistic and take on excessive risk, driving up asset valuation in the process. Excessive valuation eventually becomes unsustainable, leading to a correction and downward pressure on asset pricing. In a down-market cycle, the pendulum swings to the opposite side, leading to excessive pessimism on asset pricing and driving down asset valuation (but setting the stage for eventual price recovery).

Presently, as investors face the prospect of shrinking central bank balance sheets and restrictive monetary tightening to combat inflation, we believe they should actively consider how defensive strategies fit into their asset allocation.

Volatility Targeting Strategies

Another downside protection approach involves choosing an appropriate risk level (or target) and then switching between different levels of risky and non-risky assets (e.g., cash) to maintain the target risk level. In a Dynamic Asset Allocation (DAA) process, the allocation between risky and non-risky assets is systematic, based on a forecast of volatility relative to a target level. A DAA process's complexity comes not from new asset classes but from the trading required to adjust the portfolio to the risk target.

The cost of entering a volatility targeting strategy should be relatively invariant to market conditions. That said, however, such strategies cannot always anticipate extreme market movements, which might cause portfolio volatility to "spike" on the open — e.g., when the value on the open of trading changes sharply from the level overnight, effectively defeating the volatility forecast. This can be a problem during fast falling markets, and will also cause volatility targeting strategies to generally lag the market in steep rallies, as the allocation to cash takes time to be reduced. Sharp V-shaped recoveries have negatively affected the performance of volatility targeting strategies, just as has been experienced with defensive equity strategies.

Investors for whom managing risk is a greater focus than achieving return would benefit from a volatility targeting approach. For example, insurance companies often favor this approach because they can be constrained by risk budgets. This approach would also benefit investors who may be able to tolerate a degree of variability in their returns but not a large drawdown. Trustees and sponsors of defined benefit plans can find themselves in such a position: They need growth assets to bridge funding gaps, but with liabilities on the horizon they cannot afford to bear the brunt of market volatility while their funding ratios are under scrutiny. A volatility targeting overlay on their portfolio can offer a cost-effective way of managing risk.

Closing Thoughts

Each of these downside protection approaches has its own unique implementation implications for portfolios. For an optimal fit, investors need to be clear about their risk and return priorities when choosing one method over another.

What is clear, however, is that in an environment of heightened market uncertainty and volatility, investors need to consider the portfolio guardrails they have in place to help withstand market disruptions, in order to achieve their long-term investment objectives.

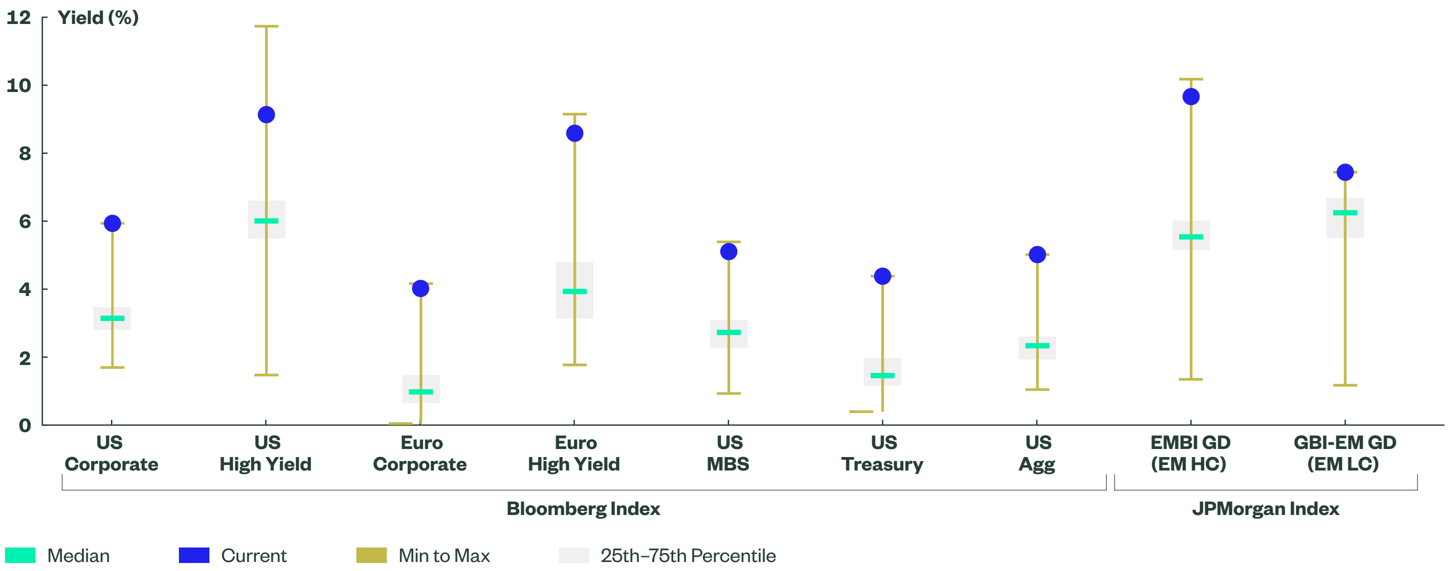
Patience Is a Virtue: Finding Opportunities in Fixed Income

Thomas Coleman
Global Head of Fixed Income Investment Strategists

Arkady Ho, CFA
Fixed Income Portfolio Specialist

The rising rate environment of 2022 has been incredibly painful for investors. Against a very challenging past 12 months in fixed income, there is a silver lining: a lift in income. Current yield levels across most of the major fixed income sectors are either at 10-year highs or at the higher end of these ranges. The yields on US and European Investment Grade Corporate bonds have risen to 6% and 4%, respectively; the yield on the 10-year US Treasury has more than doubled to 4%; the yield on German Bunds increased to 2%; and the yields on High Yield and emerging markets (EM) bonds globally have jumped to approximately 9% (see Figure 1). While price returns have been painful, investors are now getting more income from their fixed income than they have for quite a while.

Figure 1
Bond Yields Reach Highest Levels in a Decade

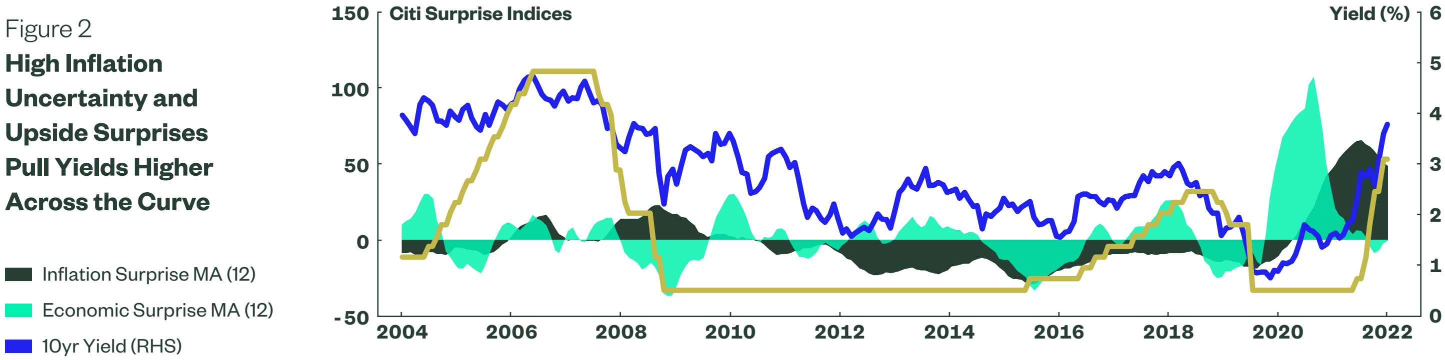


Source: Bloomberg Finance, L.P., JP Morgan Chase. Analysis uses daily yields-to-worst from October 31, 2012, to October 31, 2022. HC = Hard currency and LC = Local currency.

There is growing evidence that we may be nearing a peak in rates, as aggressive central bank policies targeting inflation take effect. This potential peak in rates could turn the very significant headwind in the bond market of the past year into a tailwind. Central banks, well into their tightening cycles but recognizing the lagged nature of monetary policy transmission, are currently walking a tightrope between appropriately restricting economic activity (to help ease inflation) and policy overtightening (causing a "hard landing" recession). Investors will have to walk this tightrope as well, and should be ready to make shifts in their portfolios as peak policy tightness draws closer and becomes more apparent.

Our message to investors is to exercise patience in choosing entry points and to maintain liquidity in portfolio positioning. Regarding timing, investors can look at trends captured in macroeconomic surprise indices (see Figure 2), the index of leading indicators, the Purchasing Managers Index (PMI), among others — all of which point to a slowing global economy.

Figure 2
High Inflation Uncertainty and Upside Surprises Pull Yields Higher Across the Curve



Source: Citigroup, Bloomberg Finance, L.P., as of October 31, 2022. Macro surprise indices are the Citi Inflation Surprise Index and the Citi Economic Surprise Index for the US. "MA (12)" denotes 12-month moving average. FFR = Federal Funds Rate.

US Treasuries as Diversifiers

Liquidity can take many forms — and is all relative. First, investors should consider the possibility that Treasuries and other developed market (DM) sovereigns could once again become effective diversifiers alongside risk assets in the coming quarters. Given high inflation uncertainty over the past 18 months, the traditionally negative correlation between equities and bonds that has persisted since 2000 has broken down and become positive in 2022. If disinflation prevails in 2023 and economic growth slows as expected, that correlation could become negative once again — i.e., with the Fed cutting rates, yields heading lower (bonds rallying), and equity valuations reflecting the deteriorating fundamental environment. This would increase the attractiveness of US Treasuries as a liquid downside protector in an asset allocation context.

High Yield as a Liquid Proxy for Private Credit

Many investors have made allocations to private credit, drawn by an attractive level of income that reflects a significant liquidity premium. The drawback of private credit is that its liquidity can best be described as periodic, and many investor portfolios require more flexibility. Cash generated from private investments requires reinvestment, and the structure of private investment programs often requires committing capital up-front with deployment of those assets dependent on investment opportunities. Therefore, an investor in private credit must consider where to keep cash associated with the private program. Of available alternatives across public markets, High Yield bonds stand out as having a yield level approaching that of private credit along with a relatively high correlation with the quarterly marks of private assets (see Figure 3).

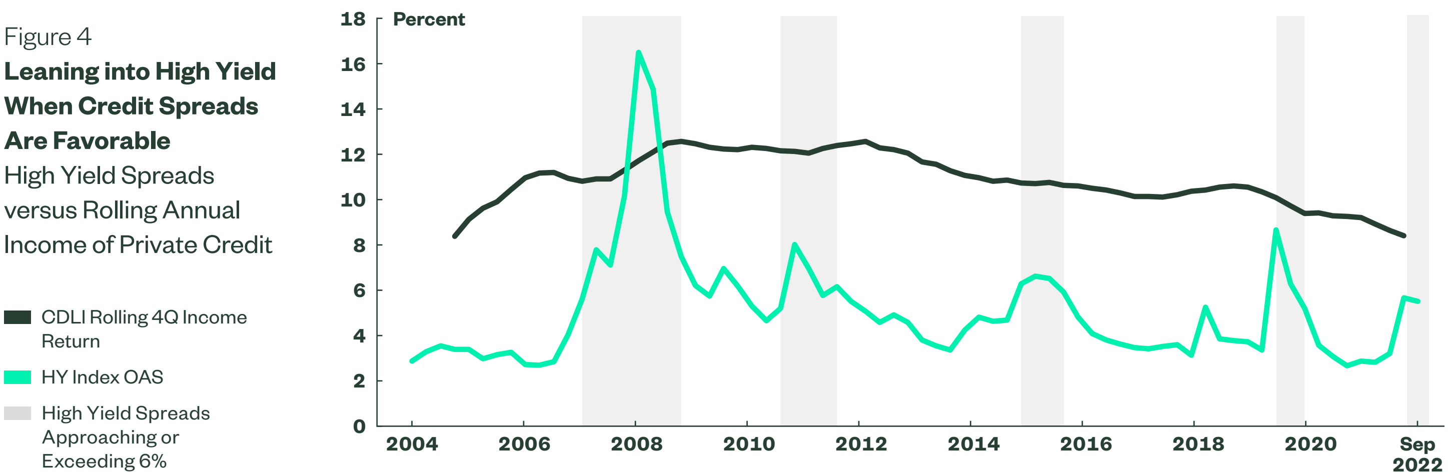
Figure 3
High Yield: A Close Liquid Proxy for Private Credit

Asset Class	Mark-to-Market/ Liquidity	Correlation with US Private Credit* (Quarterly Return)	Expected Yield** (%)
US Private Credit*	Periodic	—	8-12
US High Yield Index	Daily	0.81	5-9
US Aggregate Bond Index	Daily	-0.06	2-5
S&P 500 Index	Daily	0.67	1-3
Cash	Daily	-0.30	0-2

*Private credit is represented by the Cliffwater Direct Lending Index (CDLI). ** Expected yields are based on historical ranges for the trailing 10-year period. The Bloomberg US Treasury Bellwethers 1-month Index is used as a proxy for cash.
Source: Cliffwater Direct Lending LLC, Bloomberg Finance, L.P., as of June 30, 2022. Analysis is based on quarterly returns going back to June 2012.

While the periodic mark-to-market of private credit yields benefits in terms of enhanced income and "stable" pricing, investors looking to take advantage of market dislocations would find themselves challenged to do so if investing only in private markets. By using the liquidity and volatility of High Yield, investors can take advantage of widening spreads by buying credit when it falls in price during market dislocations, with the intention of redeploying in private credit or other alternative asset classes when those opportunities arise. In Figure 4, we have identified five instances where High Yield spreads approached or exceeded 6%, representing points in time when buying High Yield as a proxy for private credit capital would have resulted in enhanced returns.

Figure 4
Leaning into High Yield When Credit Spreads Are Favorable
High Yield Spreads versus Rolling Annual Income of Private Credit



Source: Cliffwater Direct Lending LLC through June 30, 2022; Bloomberg Finance, L.P., as of September 30, 2022.

Be Patient in Waiting for Attractive Entry Points on Credit

Credit spreads have widened this year from near-historic tights and are now at levels that are in the context of long-term averages. We think credit will be a buying opportunity in the coming quarters, but it still faces some near-term headwinds. A key headwind is an aggressively tightening Federal Reserve that the market expects will raise the Fed Funds rate to 5% in the first half of next year. This reflects highly restrictive territory and will further dampen economic activity. These tightening effects have, for the most part, not yet shown up in credit fundamentals, but we think they will in 2023 (tightening effects have started to show more clearly in macroeconomic fundamentals). Investment Grade credit fundamentals, although slowing, continue to hold up: Profit growth remains above pre-Covid averages, while interest coverage ratios are near historical highs. On the High Yield side, spreads remain slightly rich to longer-term averages, and do not reflect the uptick that some analysts are predicting in High Yield defaults next year.

Closing Thoughts

We need to see clearer signs that the Fed is prepared to actually pivot off of its policy tightening path in order to make credit, particularly High Yield, an attractive investment opportunity. Even after the 75-basis point hike in November, the Fed still has multiple rate hikes left to implement before it pauses, barring some unforeseen strong downside macroeconomic surprises. In the meantime, momentum is likely to remain negative, fundamentals are likely to weaken, and spread valuations are likely to widen further to more attractive levels. Patience is prudent while waiting for the macroeconomic and policy picture to become clearer over time — we're not there yet.

The US Dollar

Keeping a Close Eye on the Dollar

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2022 has been an incredibly challenging year. Fixed income and equity markets have been hit hard by high yields and rising growth risks, which have largely been attributed to persistently high inflation, a near record-setting pace of monetary tightening, geopolitical uncertainty, and lingering impacts from Covid (particularly in China). Following a decade of strong outperformance, US equity markets have continued to outperform developed markets (DM) and emerging markets (EM) in 2022: The MSCI USA Index has outperformed the MSCI ACWI ex USA Index by 1.5% year-to-date.[3]

However, despite these challenges, we do see signs of opportunity. A historically strong US dollar (USD) has contributed to this outperformance year-to-date, and since the end of 2020. However, stripping out the impact of the surging USD, the MSCI ACWI ex USA Index actually has outperformed the MSCI USA Index year-to-date in local terms. This is particularly relevant for investors because we see a strong case that the USD should reach its peak and begin to decline in 2023.

A Supercharged US Dollar

The USD has been supercharged by a combination of rising relative yields and its appeal as a safe haven during a tumultuous time. Near term, high yields and rising recession risk are likely to continue to support the dollar and keep us in a defensive stance, i.e., underweight equities. Looking forward to next year, however, we expect a gradual change in this economic regime. A key driver of this change is a transition from inflation to disinflation and a policy shift by central banks to focus on growth. This shift should result in lower yields, thereby helping to build confidence that global growth will stabilize and eventually recover. In other words, rising yields and recession risk, the two key supports for the USD, should abate and send the dollar lower, thereby opening the door for a broad rally in risk assets, particularly non-US equities.

A defining feature of USD strength is its safe-haven appeal during periods of heightened geopolitical risk. Such risks have depressed 2022 economic performance outside of the US, most notably in Europe and China. The "probability of outcomes" favors the creation of an improved environment in which ex-US growth narrows the gap with US growth. In Europe, the Russia-Ukraine War has delivered a full stagflationary energy shock, which we believe will continue to ripple through 2023. However, markets have largely priced-in the war. Going forward, marginal negative shocks are less likely to impact markets than the continuing geopolitical status quo, or even de-escalation. It would be naïve to ignore tail risks — the use of nuclear weapons, new humanitarian disasters, or sabotage of European energy infrastructure — but the probability of additional significant macroeconomic shocks is diminishing. While the perception of increasing tail risks may rise with Ukrainian success on the battlefield, the re-capturing of Russian-held territories by Ukraine also serves to bring the conflict closer to an endgame or stabilization scenario.

China's Zero-Covid Policy has constrained growth throughout 2022. China will almost certainly loosen restrictions over the course of 2023, with the magnitude and speed of economic effects still to be determined. This loosening is certain to lift Chinese growth relative to 2022, and thus will also help narrow the gap versus ex-US growth. We think that increased geopolitical fallout from US-China tensions is only likely once China has fully normalized its economic conditions — so the near-term outlook is encouraging on that front, too.

Equities

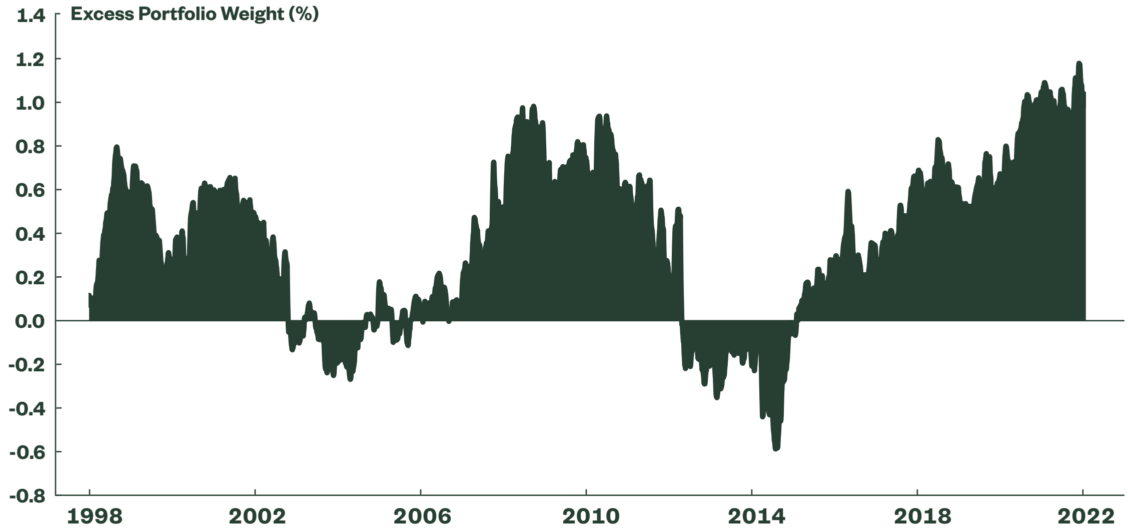
We view the outlook for equities through the following primary lenses: fundamentals, valuations/discount rates, and positioning.

Fundamentals have been strained globally in 2022, and we expect this to continue into 2023. The global outlook, ex-China, shows deceleration almost everywhere, suggesting that after a rather weak 2022 we will see only a mild rebound for earnings in 2023. Earnings in the US have improved slightly so far in 2022, but are likely to see some significant headwinds with the sharply rising dollar. We do not expect any major equity region to generate better than mid-single-digit earnings-per-share (EPS) growth next year. The clear advantage that the US has had in EPS growth may now be in question.

Valuations of non-US equities are at average levels, while valuations of US assets remain relatively overpriced. It is difficult to say that non-US assets are attractively priced, either in DM ex-US or in EM, which have declined 30% this year. Both EM and DM ex-US are trading fairly close to their long-term averages, but remain relatively inexpensive relative to US stocks. Historically, appealing price levels have not been enough (by themselves) to attract significant flows, given the high profitability differential and innovation advantage of US companies. If valuation levels were very cheap relative to history, some investors would look to pick up exposure and be happy to hold it, awaiting future improvements. However, we are yet not at that point. On the flip side, rising rates are likely to put valuation pressure on long-duration assets, of which the US has multitudes.

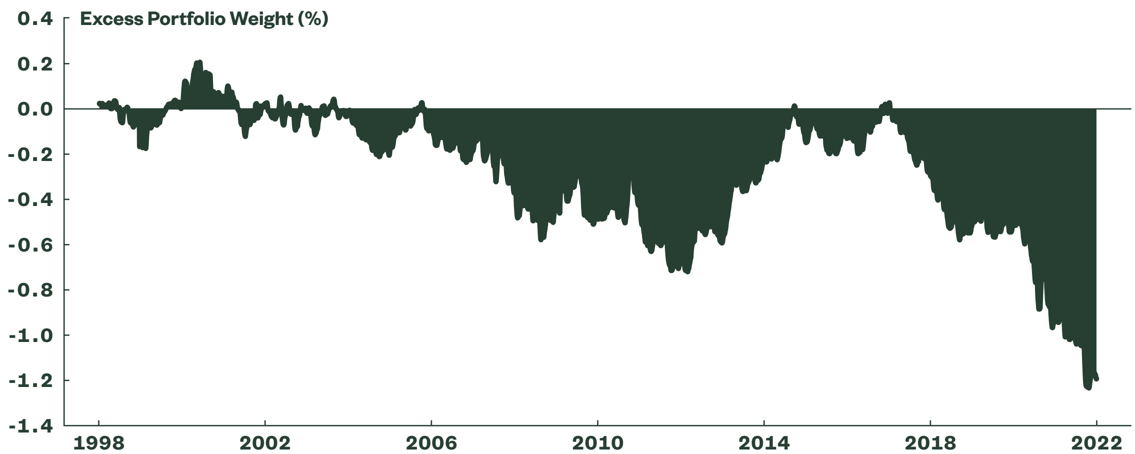
Positioning is a critical area where we see an upside to non-US assets. Other global economies are significant long-term investors in USD-denominated assets. Institutional owners have the highest overweight to the US in approximately 25 years (see Figure 1). In contrast, institutional owners have strong underweights to emerging markets across a similar time frame (see Figure 2). Will this trend persist long-term? We think the likely answer is no, and conditions may suggest a reversal. This evolution will require a catalyst of some sort to encourage investors to take positions outside of the US safe-haven currency. Historically, positioning at these levels has not stayed this one-sided for long — something will move. While the timing of a catalyst may be uncertain, we think some level of repositioning makes a great deal of sense over the medium term. The time is now to prepare one's trades.

Figure 1
Institutional Owners' Overweight to US Dollar Assets
United States Equity Holdings Indicator



Source: State Street Global Markets. Data as of October 19, 2022.

Figure 2
Institutional Owners' Underweight to EM Assets
Emerging Equity Holdings Indicator



Source: State Street Global Markets. Data as of October 19, 2022.

Key Takeaways for Investors

- The strong US dollar is a headwind to international equities; emerging markets are most negatively affected by a strong dollar.
- The US dollar is at historic heights, which might suggest a reversal is on the way.
- With increased value exposure outside the US, value outperformance could be a tailwind for non-US equities.

Endnotes

1 Seasonally adjusted annual rate.

2 The difference between 3-month Treasury bills and 10-year interest rates in the United States.

3 As of September 30, 2022.

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