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Where Next for Markets in 2023?

Bond yields look attractive and non-US equities may merit a closer look.

Insight from sub-adviser Schroders Investment Management

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It's a gloomy time of year in more ways than one at the moment. Even the excitement of my recent move to a new house can't distract from the literal and figurative darkness of January 2023. The war in Ukraine is dragging on and the specter of recession looms large, to name but two dark clouds over us all.

Just as a new house brings a fresh start, a fresh calendar year is an opportunity for active investors to look to the future. And as we peer through the present gloom, we see some causes for optimism. Following the poor performance and significant declines in equity and bond markets in 2022, we now see some attractive valuations. And I'm reassured that whatever comes next, we have the processes and teams to cope.

Recessions are tough for everyone. But, from an investment perspective, this is also when we can find fresh opportunities. Indeed, it's important to remember that, historically, some of the best opportunities for equities, for example, occur in the midst of recessions. Markets always move ahead of economic news.

Key Points

- Our previous strategic view suggested that investors should think about what they did over the last decade, and do the opposite. This view still stands.
- While we can't assume fixed income and equities will move in opposite directions as has been the norm historically, we believe fixed income offers attractive yields and diversification.
- Investments in regions outside the US may offer more compelling values going forward. The end of China's zero-COVID-19 lockdown restrictions bodes well for Asia's prospects.

Investing in a New Era

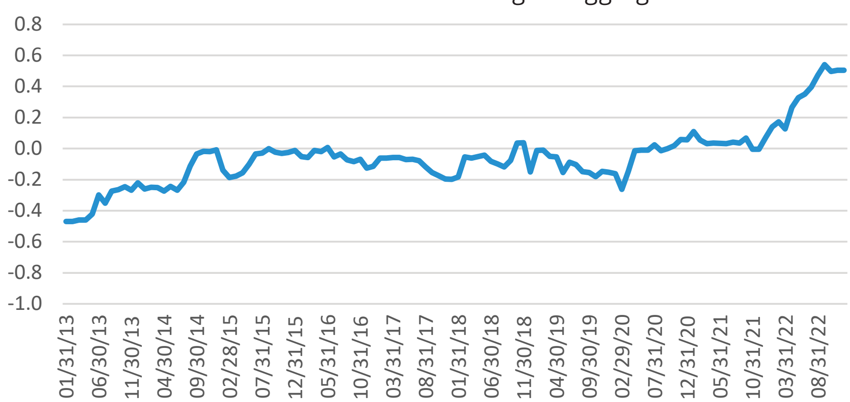
Over the last couple of years, we've talked regularly about disruption and regime change, as we move into an era in which both inflation and interest rates nestle into higher ranges. With this in mind, I've previously summarized our strategic view as "think about what you did over the last decade, and do the opposite." This still stands. So, what does that mean for markets in 2023?

Let's start with the epicenter of weakness in 2022: fixed income. As I mentioned, we believe inflation will be structurally higher over the next few years due to deglobalization and decarbonization. There will still be cycles in inflation, of course, but we expect that central banks won't get back to the zero-rate policies of the 2010s. This means we can't assume that fixed income will be negatively correlated with equities over the medium term. However, with the repricing of yields in 2022 and the risk of recession in 2023, we think fixed income offers an attractive source of yield and diversification.

FIGURE 1

Stocks and Bonds Usually Go in Opposite Directions—Since 2020, Not So Much

Correlation[1] between S&P 500 and Bloomberg US Aggregate Bond indices



[1] Correlation is a statistical measure of how two investments move in relation to each other. A correlation of 1.0 indicates the investments have historically moved in the same direction; a correlation of -1.0 means the investments have historically moved in opposite directions; and a correlation of 0 indicates no historical relationship in the movement of the investments.

Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. As of 12/31/22. Data based on rolling 3-year average returns of the S&P 500 Index and the Bloomberg US Aggregate Bond Index between 2013 and 2022. See page 3 for index definitions. Source: Hartford Funds.

We expect geopolitical tension to continue to run high, but these risks are impossible for investors to time or predict given their binary nature. Our main defense is diversification and identifying exposures that might protect us from geopolitical news—but which we also like for other reasons. In this regard, we continue to believe that strategic allocations to commodities and commodity-related investments may provide some protection from geopolitics as well as inflation risks.

Look Beyond the US

The last decade was dominated by the outperformance of US assets—both equities and bonds. We now see benefits to greater regional diversification.

Within fixed income, a number of emerging markets (EM) are further along in the battle against inflation and have reasonably solid macroeconomic fundamentals. Given the high level of yields—particularly in local currency-denominated bonds—and the level of underinvestment in this asset class due to turbulence over the last decade, we see opportunities for 2023. Our EM debt team has highlighted local-currency bonds in Mexico, Brazil, Indonesia, South Africa, and a number of dollar-debt frontier markets such as Angola and Ivory Coast as being particularly appealing.

We're also starting to differentiate more within equities as regions outside of the US offer more compelling valuations. Underlying US margins, after a prolonged period of strong execution, are at record levels. As we've seen with the tech sector, cost pressures in the US are now making themselves apparent at a time when revenue growth is clearly starting to slow. Negative operating leverage—in which fixed costs comprise a greater portion of a company's total cost structure while sales decrease simultaneously—is beginning to kick in. Yet Wall Street still expects 6-7% earnings growth for the S&P 500 Index in 2023, which seems optimistic.

China on the Rise Again?

The rest of the world definitely looks more interesting, however, especially Asia. China is likely to accelerate quite strongly out of its extended period of strict COVID-19 lockdowns. Our Asian equities team expects a sharp recovery in consumer spending to kick in from the second quarter on, supporting domestic earnings in many sectors of the Chinese economy.

Lastly, a word on overall risk levels. While rate expectations are now more realistic and we expect interest-rate volatility to stabilize, we also expect liquidity to remain tight in the next few months. Combined with the risk of recession, we believe more pro-cyclical positions need to be balanced with lower allocations to US equities. It may be prudent to keep some dry powder for the opportunities likely to appear.

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For more insights on equity and fixed-income opportunities, talk to your financial professional.

S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

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