Three Themes That Could Define 2023 for Income Investors

For investors seeking income, here are some important ideas worth keeping on your radar.

With global bond yields up and dividend stocks looking increasingly attractive, 2023 could be a good year for income-seeking investors.

But there are several macro crosscurrents at play, so it's important to not lose sight of the big picture. With that in mind, here are three broad themes that we think should be top of mind for income investors (actually, for all investors) in 2023.

THEME 1: Timing the Global Recession

From an economic-growth perspective, a soft and shallow global recession is our base case as of this writing, although we're carefully monitoring both upside and downside risks. On one hand, a more severe downturn could materialize if financial-sector fragilities were to be exposed, including high levels of private-sector leverage, falling real-estate prices, and the risk of permanent capital erosion from write-downs in private investments. On the other hand, a stronger-than-expected or faster-than-projected rebound of China's economy could provide a global economic stimulant, with increased Chinese demand for crude oil, copper, and other commodities benefitting exporters of such goods. While we believe the true impact of China's economic reopening is more likely to be felt later in the year (given the recent COVID-19 wave that swept across the country), the actual timeline will be worth tracking.

Meanwhile, global inflation appears to have moderated somewhat, with consumers in many countries now experiencing some relief from the inflationary pressures that had been building for the past year or so. Recent cyclical weakness, coupled with a milder-than-expected winter-heating season in Europe thus far, have led to falling energy and food prices worldwide. Fixed-income markets have recently started to price in interest-rate cuts in the second half of 2023, on the back of lower global growth forecasts. However, we believe economic conditions would need to deteriorate meaningfully for the major central banks to change course on monetary policy. In our judgment, a shallow, soft recession wouldn't be sufficient to reduce inflation to central banks' target levels. We therefore think pauses in their interest-rate hikes later this year look more plausible at this point than rate cuts.

Actionable takeaways for income investors to consider:

- Keep portfolio duration[1] (interest-rate exposure) relatively low.
- Increase allocations to high-quality, short-duration credit.
- Maintain allocations to defensive equities and real assets.[2]

THEME 2: "Go Global" in the Search for Return

Concerns regarding valuation and a challenging outlook for corporate profits could remain stiff headwinds for US equities in 2023. While a soft and shallow US recession is our base case, bottom-up earnings estimates look overly ambitious, whereas corporate earnings have historically tended to drop 20% to 30% ahead of recessions. We therefore suggest that allocators approach the US equity market

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Key Points

- While fixed-income markets have started pricing interest-rate cuts for the second half of 2023, we think central banks are more likely to pause rates, not to cut them.
- We believe investors should consider keeping their interest-rate exposure relatively low and increase allocations to high-quality credit and defensive equities.
- While we suggest a cautious approach to US equities, we also see a potential for a relative recovery in international markets. Consider maintaining portfolio liquidity[3] to take advantage of market dislocations.

with caution and selectivity, focusing on pockets of opportunity where valuations may be attractive. From a volatility perspective, fears around recession risk often contribute to heightened single-stock volatility (especially within cyclical sectors), even if index volatility reverts back to lower levels.

Outside of the US, we are positive on many international markets and see a potential recovery in relative performance in 2023, following many years of underperformance. However, this will depend, to a not-insignificant degree, on the strength of Asian economies from here and on further developments in the Ukraine-Russia war—areas we will continue to monitor closely. For example, ~20% of European equities are driven largely by product sales to Asia, so a potential rebound in Chinese economic growth is obviously critical to the future prospects for this asset class.

We suggest that allocators consider approaching the US equity market with caution and selectivity, focusing on pockets of opportunity.

Actionable takeaways for income investors to consider:

- Look for credit and equity opportunities outside the US, notably in Asia and Europe.
- Within the US:
  - Favor market segments with cheap valuations, such as small-cap equities.
  - Elevated single-stock volatility may enhance income generation from certain options strategies.

THEME 3: Market Fragilities May Cause Further Dislocations

Mixed macroeconomic data and a wide range of potential outcomes, each with associated downside risks, have often led to one-off liquidity events and/or market disruptions on which discerning, opportunistic allocators can seek to capitalize.

For example, consider the turmoil that beset the UK fixed-income market in September 2022. Some income investors used that episode to their advantage by initiating select positions in UK investment-grade corporate bonds with outsized yields and temporarily depressed values. In our view, such periodic asset dislocations are likely to remain a key feature of the global landscape in 2023 and perhaps beyond. They can offer interesting entry opportunities for allocators with ample liquidity who are able to rotate quickly in response to changing market environments.

Actionable takeaway for income investors:

- Consider maintaining adequate portfolio liquidity, particularly in fixed-income allocations, to be able to move swiftly to exploit market dislocations as they may arise.

Talk to your financial professional for help with seeking to enhance your portfolio's income-earning potential.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[2] Real assets are physical assets that have an intrinsic worth due to their substance and properties. Real assets include precious metals, commodities, real estate, land, equipment, and natural resources.

[3] Liquidity refers to the efficiency or ease with which an asset or security can be converted into ready cash without affecting its market price. The most liquid asset of all is cash itself.