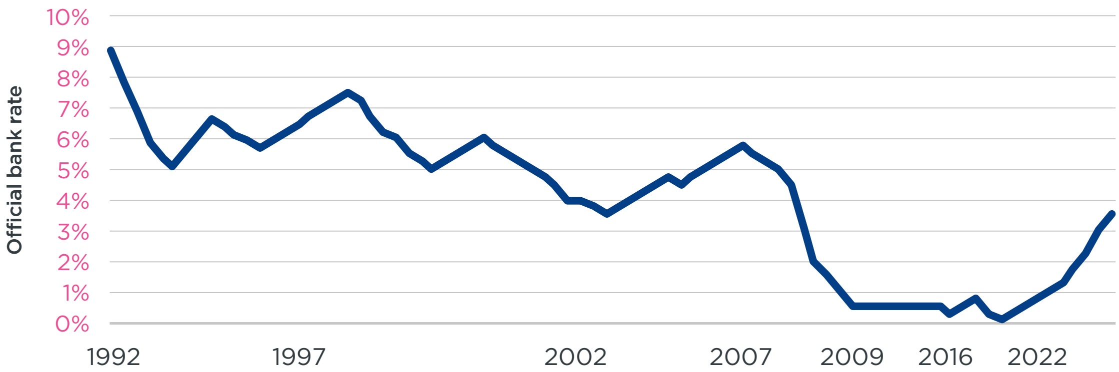
Investment briefing
January 2023

Outlook for 2023: Back to the 90s?

Alasdair Gill, Head of Equities at XPS Investment, reflects on 2022 as a challenging year for investors, and looks back to the 1990s for some pointers that could be helpful in navigating the investment road ahead.

We have lived through an extraordinary period in markets (particularly in the last 15 years) – an era of 'cheap money', with ultra-low interest rates meaning that the cost of capital for businesses was low and stable, and negligible inflation meant that there was no eating into real returns for investors – this kept salary growth low and stable too.

Chart 1: UK base rates since leaving the ERM



Source: Bank of England

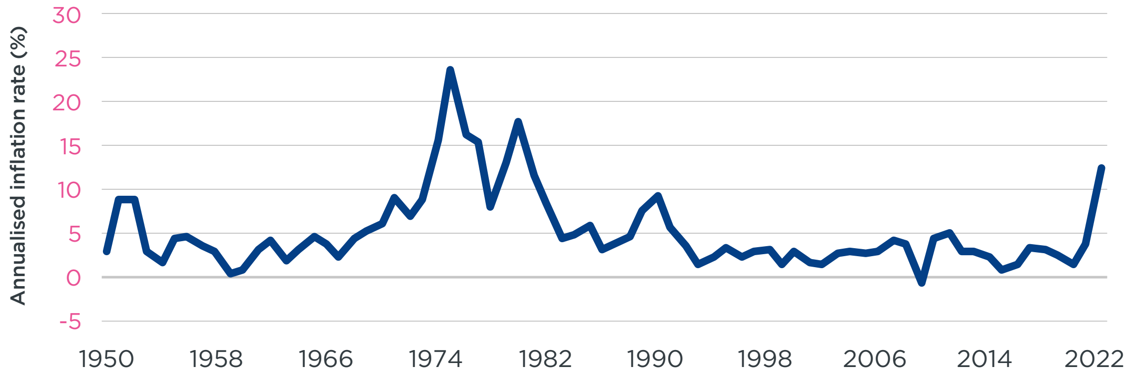
2022 saw an end to all that – inflation was already picking up when we started the year, but the idea that it was "transient" quickly disappeared following the Russian invasion of Ukraine, which pushed up fuel and other costs, and saw interest rates climb sharply from the near zero state up to levels we have not seen since the global financial crisis.

We have also seen the start of wage inflation, and the resultant strike action in the UK as workers in many industries fight for cost of living increases to maintain living standards. This has resulted in faltering economic growth, as the UK economy still struggles to grow beyond pre-covid levels of 2020.

All of this starts to feel (for those with longer memories) a bit like "business as usual" prior to the global financial crisis ('GFC'), when inflation was a regular feature and needed to be kept in check, and the experience of the 70s (with real runaway inflation) was fresh in the minds and had to be avoided at all costs.

Unemployment was the other big societal problem in the 1980s in particular, but it was still around in the 90s, albeit more under control – what we have now is "underemployment" with many (particularly older) members of the workforce not actively seeking work. Will this continue?

Chart 2: Post WWII inflation



Source: ONS

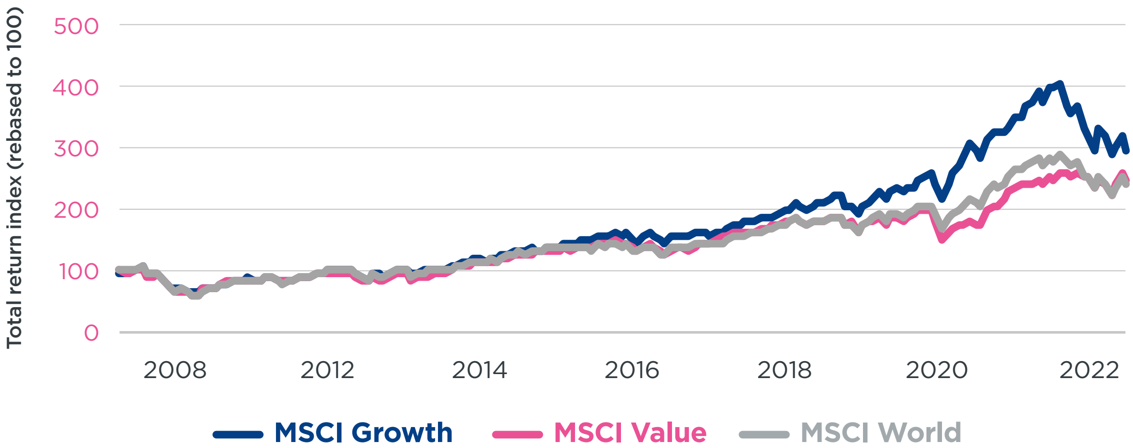
Most economic commentators seem to be predicting a recession in developed economies in the early part of the year, and we concur, although regardless of whether there is a technical recession in the UK, we do expect the slowdown to weigh on markets during 2023.

So what does this mean for investment markets, particularly for institutional investors? Here are a few ideas we have for Trustees and other stakeholders to both capitalise on opportunities, and manage the downside risks.

Growth markets outlook

Equities — is 'value' set to shine?

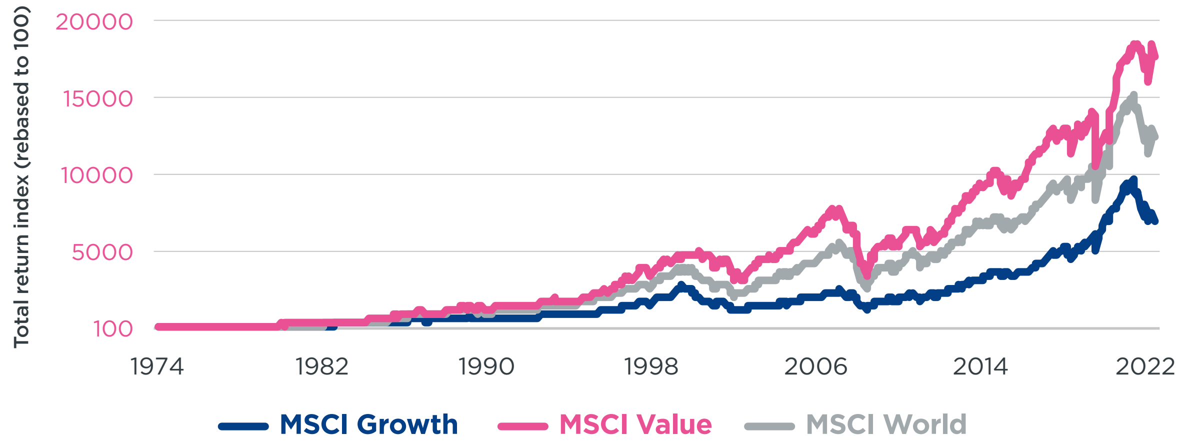
Chart 3: MSCI value vs growth since GFC since 2007



Source: Refinitiv Datastream

Within equities, investors had a torrid year with the FTSE All World Index down 7.3%. However, this was a year of massive dispersion of returns, with one sector dominating – energy. This played in to the 'value' style of investing, a style long lauded by academics, which had underperformed pretty much most of the 21st century. However, looking at MSCI 'growth' vs 'value' indices, value outperformed by around 20% in 2022 and although it is still well behind growth since the GFC (see chart 3), value still has the edge if you look back to returns since 1974, the longest period of data that MSCI quotes (chart 4). With the normalisation of interest rates, there is a stronger argument that investors will value shorter term earnings and income more highly than promises of long term growth, which will play into value investors' hands – where the smart money was at in the 90s!

Chart 4: MSCI value vs growth since 1974



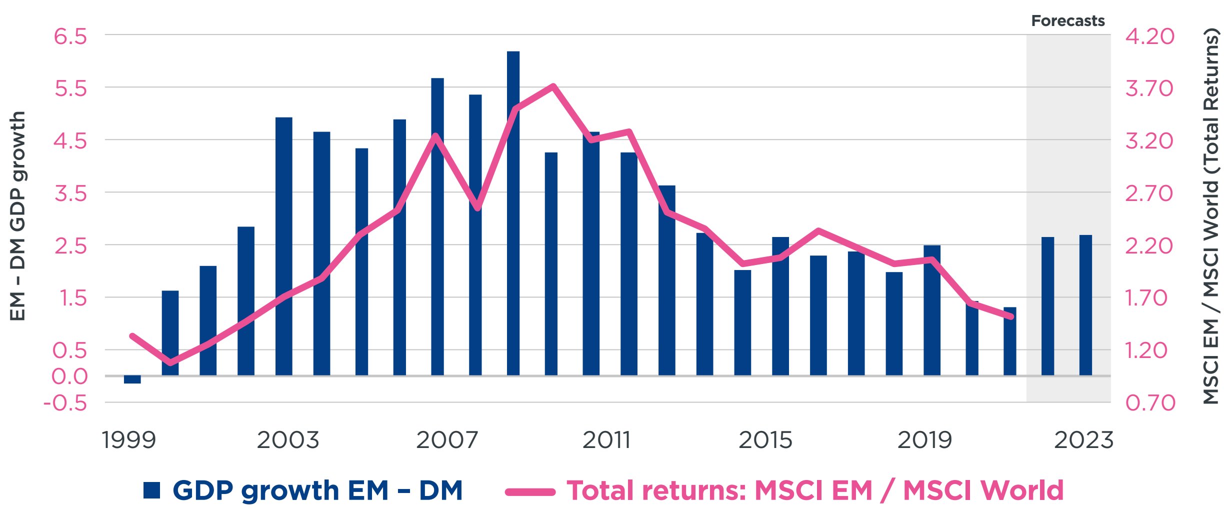
Source: Refinitiv Datastream

Looking domestically, we still see the UK as poised for a slowdown, so we continue to prefer the more diversified approach of using a global index for equity allocations, to include emerging markets (see below).

Emerging Market Opportunities — a year of inflection?

Emerging markets have been a challenging area for many years since the GFC, with the promise of benefitting from faster growing economies often scuppered by the relatively poor governance and potential for state intervention. However, with India continuing to be on the rise (and set to become the most populous country in the world by April 2023), and China finally stepping out from under the COVID shadows, we could see a stronger year for EM in 2023 – indeed the International Montetary Fund (and many EM specialists) predict a growing divergence between EM and Developed GDP growth, which has historically been good for emerging market equities relative returns (see chart below). Clearly risks remain, and with the Russia-Ukraine conflict showing no signs of stopping, the potential for this (and other smouldering conflicts, such as China – Taiwan) to weigh on global markets remains.

Chart 5: Relative EM:DM growth and market returns



Source: IMF World Economic Outlook, Ashmore. October 2022

You can now achieve a decent 5% income yield from investment grade portfolios.

Fixed Income: opportunities abound — back to the 1990s!

On a more positive note, the opportunities in bond markets truly have transformed in 2022 – gone are the days of miserly 2-3% yields from corporate bonds, and you can now achieve a decent 5% income yield from investment grade portfolios. In the UK we will soon see the end of the Bank of England's Quantitative Tightening in the non-government market (they reduced their stock by 24% in Q4 of 2022 to £13.6bn, which could be another possible catalyst for re-pricing in this market).

Chart 6: Corporate bond yield progression: IBOXX £ corporate yield

Source: Refinitiv Datastream

Defined Contribution Schemes — more options post retirement?

These changed markets will potentially result in a "re-think" for investors in the "decumulation" phase of their DC retirement pot – with a range of assets offering better yields as described above, there could be an opportunity to maintain an income in these portfolios without reducing the capital – a more "traditional" approach that almost disappeared since the GFC – again, we may be dusting off the investment textbooks from the 20th century for tips here!

Remember: illiquidity is not a free lunch!

Liquidity will continue to be a challenge for pension scheme trustees in the DB landscape – which was also transformed in 2022. Those that were not highly hedged saw their funding levels generally improve, which meant they could move to lower risk investment strategies, and sell out of higher risk asset classes, if there was liquidity. Those that were hedged needed to find that liquidity quickly to maintain any leveraged LDI positions, and this did expose the limitations of illiquid and semi-liquid asset classes.

In 2023 we expect many schemes to review their liquidity budgets in more detail, and ensure they have more headroom for maintaining any leveraged positions to avoid any possibility of a repeat of the crisis of 2022. Other investors could find opportunities to pick up private market secondaries for a decent discount, if they do have scope. We expect to see more of this in 2023.

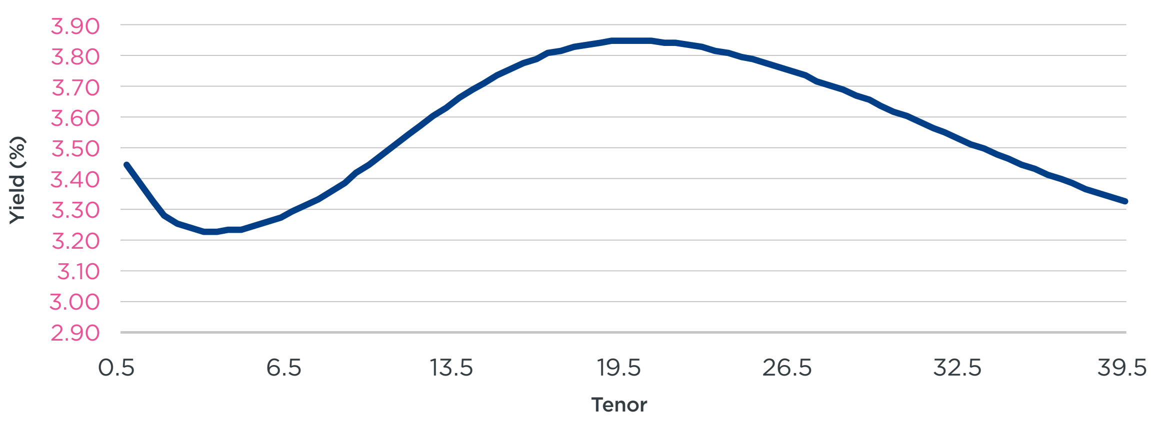
Practical tips for the DB Pensions Trustees — hedging is still important!

Just because rates have increased, it does not mean this will continue indefinitely! Combined with volatile inflation, the discipline of liability hedging remains important, noting that there may be a higher cost involved (particularly as more assets need to be committed for the same level of exposure if using leverage).

Those with more flexible arrangements, can consider liquid collateral with a higher return potential (for example, Asset Backed Securities) to help mitigate these costs.

Finally, we recommend that trustees review their hedge levels in 2023, following the turbulent year we have seen – it may be the case that your funding level has improved, and that less leverage is needed to maintain your hedge, as you could release growth assets to deliver the hedging using physical assets. Note that simply using longer duration bonds to increase duration and avoid the need for leverage can also be expensive as the longest bonds are currently lower yielding (50 year yields are lower than 30 year – see chart below). This can introduce different risks if the shape of bonds held doesn't match liabilities.

Chart 7: Nominal gilt yield curve – 12 January 2023



Source: Bank of England

It may be the case that less leverage is needed to maintain your hedge.

Summary

Market conditions have massively changed over 2022, more than could have been predicted as inflation took hold, partly fuelled by the first major European conflict for many years – this has led to many questioning how they should react in relation to their investment portfolios.

Fortunately, we have been here before. Back in the 1990s we saw similar conditions, and we just need to re-learn the investment disciplines of an earlier time:

- **bonds can deliver a decent yield and so can really help cashflow needs;**
- **inflation can erode nominal returns and so cannot be ignored or assumed to be benign;**
- **interest rates can go up as well as down which and central banks don't always get things right.**

Some of these aspects can conflict with each-other so it is more important than ever that Trustees and fiduciaries are crystal clear on their investment objectives and review fundamentally where their portfolio sits, and what changes need to be made, as we head back to the future!

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