MID-YEAR INVESTMENT OUTLOOK 2023

WHAT CHALLENGES AND OPPORTUNITIES COULD INVESTORS BE FACING?

Coutts

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THE BIG PICTURE

Global equity markets have recovered from their lows in autumn 2022. The important changes in geopolitics and world trade that affected markets last year are less of a driver this year. This highlights the short-term nature of financial markets. At the moment, it seems easy to argue for both the positive and negative scenarios for the economy and equity markets. But key financial indicators rarely move in perfect lockstep, especially in the current post-pandemic world.

A BRIGHTER FUTURE?

The main themes of 2022 – rising inflation and interest rates – could now be behind us. But the effects of those rapid rate hikes, combined with declining corporate earnings and the continued likelihood of a US recession, mean potential challenges still lie ahead.

SECTION 1:
WHAT'S HAPPENED SO FAR?

POSITIVE START TO THE YEAR

The performance of many developed economies in H1 2023 turned out better than initially expected. A mild winter, fiscal aid packages, better consumption and tight labour markets have delayed a meaningful growth slowdown. Inflation has been decelerating since the start of 2023 – the UK is an exception, but that will likely change in the second half of the year. And after a fast-paced rate hike campaign that led interest rates to a range of 5-5.25% in the US and 5% in the UK, central banks are now signalling that they could be close to the end of their hiking campaign. Although that's still somewhat data dependent.

NOT ALL GOOD NEWS

However, looking at data and financial market performance, a feeling of uncertainty remains. On one hand, oil prices are falling despite OPEC supply cuts, costs of financing for consumers and businesses keep rising, house prices are falling, and small US companies' optimism is at a decade low. On the other hand, US and European growth is better than forecasted and corporate earnings, while dropping, have remained more resilient than expected six months ago.

A MIXED BAG

There's a similar contrast in financial markets where the yield curve remains unusually inverted (when short-term yields are higher than long-term yields). The bond market expects a recession and is pricing in an expected, quick policy shift toward cutting rates in the US. At the same time, equity markets have performed well so far this year. Volatility has declined and credit has remained stable, despite concerns about real estate and the US regional banking sector.

ENCOURAGING RESULTS FOR INVESTORS

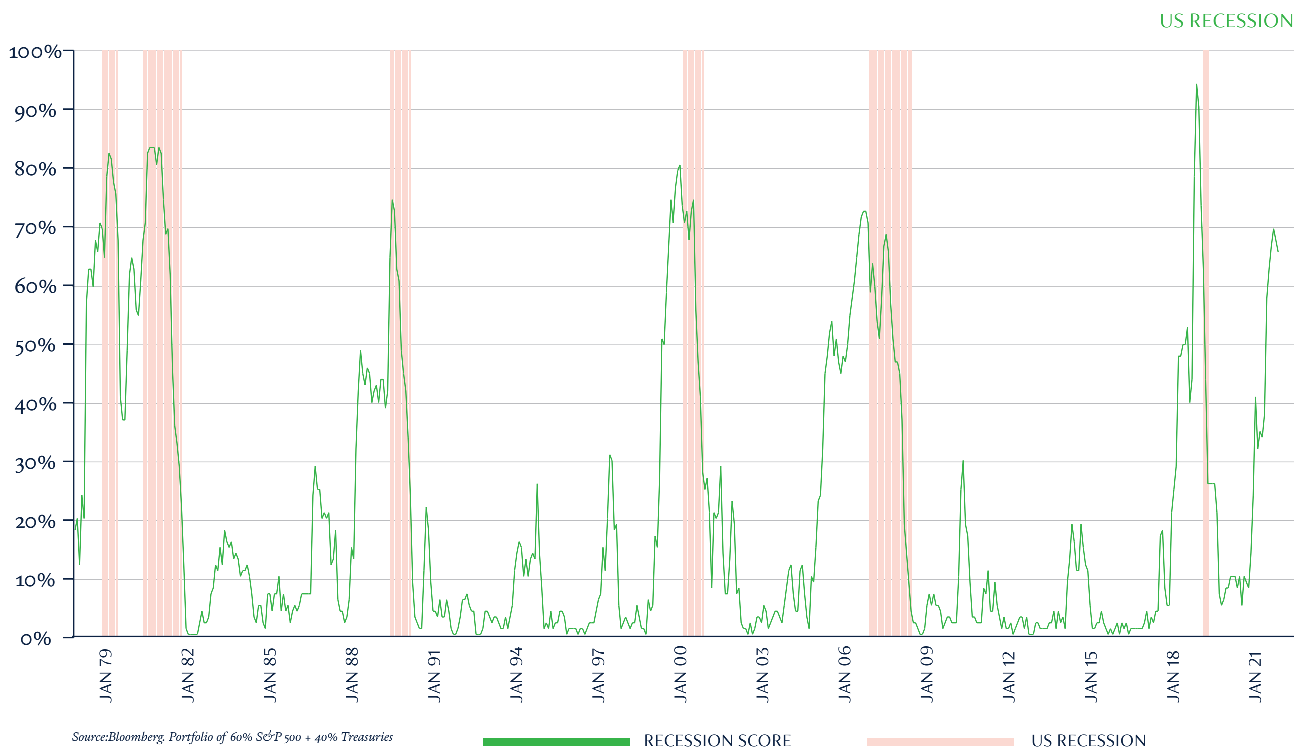
Considering these cross currents of data, our client portfolios and funds have performed positively so far this year (at the time of writing). Both large-cap equities and bonds have recorded gains, with the latter also providing some resilience during the banking sector stress in March. Looking at the past 12 months, many equity markets are now positive, although with considerable volatility along the way. This is a good example of why time in the market is important, ignoring the daily noise and remaining focused on long-term investment goals.

SECTION 2:
OUR MACROECONOMIC OUTLOOK

It's easy to argue both the positive and negative narratives for the economy and equity markets. But if we look deeper, it seems that the likelihood of a US recession is still the main story of 2023. Let's start with the weight of the macroeconomic evidence and why it still seems appropriate to steer a more cautious course in the coming months.

US RECESSION WATCH

Despite better-than-expected growth, our US recession indicator still flags a recession as a very likely outcome over the coming 12 months, as it's at levels that have typically come before a recession. As you can see in the graph, when this indicator exceeds levels of around 50%, a US recession usually follows.



The drivers of the elevated indicator are an inverted yield curve, declining building permits, and weak consumer sentiment and manufacturing outlook.

HOPE ON THE HORIZON

Not all indicators confirm this outlook though. The level of credit spreads (the excess yield required by investors to purchase lower-quality issuers) is currently at levels consistent with a more optimistic economic outcome. However, credit spreads have an unconvincing history when it comes to anticipating a recession and usually only reprice wider after a delay – once a recession is underway.

LABOUR MARKET WILL BE KEY

The biggest sign of whether or not we see a US recession will come from the labour market. In the consumer-centric US economy, a recession can't come until unemployment rises and consumption declines as a result. Historically, a deterioration in the labour market tends to happen very near a recession or when one has just started. So we're likely to see investors focus on America's job market to see where the country's economy is headed.

THE 'NO RECESSION' SCENARIO

Our base-case scenario of a US recession could be too early or wrong if the US has a continuously strong labour market. This could delay a recession or even transit the economy into a recovery without a recession at all. With an eye on the upcoming presidential election next year, the US government has an incentive to use fiscal policy to keep up economic momentum and contain job losses.

However, while this possibility can't be ruled out, the reality is that it would be very difficult to engineer while simultaneously keeping inflation under control, which remains a declared aim of central banks and governments.

HIGH INTEREST RATE RISK

While the first half of this year was marked by tension between resilient economies and elevated US recession risks, one upcoming narrative is likely to be centred around the delayed impact of rapid interest rate hikes. Those rising rates led to concerns over systemic risks in the US banking sector in March. Such developments ultimately determine the severity of economic downturns, along with the US Federal Reserve's (Fed's) response to them.

THE IMPACT OF RECENT RATE HIKES

The market volatility experienced by the US banking sector in March was a reminder that the impact of monetary tightening can be sharp and sudden. It's now been 18 months since the Fed embarked on what was the fastest and largest series of rate hikes in the last 40 years. Its impact on the economy is only starting to appear now. Interest-rate-sensitive sectors, especially where debt or profitability is an issue, are showing some stress.

In particular, commercial real estate companies in Europe and the US are on investors' radars as high refinancing costs and a wall of maturing loans ($448 billion in 2023 in the US, according to Trepp) are confronted by 'working from home' trends that have hit office spaces.

DEFAULTS RISE

Finally, consumers are spending their way through much of their pandemic savings and taking on debt to keep up with inflation. As a result, consumer finance like car and credit card loans have seen defaults rising due to rising financing costs. In the US for example, the average used car loan payment for consumers is up 35% versus pre-Covid, according to Citi and Cox Automotive. While defaults remain contained for the time being, this is mostly explained by the record low unemployment rate. The risk is that once the labour market deteriorates, consumer spending – and with it the economy – declines.

OPPORTUNITIES UP AHEAD

Overall, the big picture looks uncertain, considering the contrast of positive equity returns and cloudy macro-economic data. It's challenging to make economic forecasts in this environment, and there are plenty of reasons to be cautious. But we also acknowledge that financial markets have been under pressure for 18 months already. So while we favour a modestly cautious positioning for now, we continue to think opportunities will present themselves later this year – as we said in our 2023 Investment Outlook in January. These opportunities could come from small caps or emerging market equities for example, and potentially the banking sector.

SECTION 3:
U.S. EARNINGS FACE CHALLENGES

THE OUTLOOK FOR US CORPORATE EARNINGS REMAINS CHALLENGING.

Q1 earnings season this year was better than expected, beating expectations that have been persistently revised lower throughout the past year. Coming into this year, Q1 earnings were expected to decline by around 1% year-on-year. By the time earnings season began, this expectation had fallen to an 8% drop. With Q1 results season largely complete at the time of writing, the actual growth looks set to come in at around a 3% fall.

This will mark the second consecutive quarter of negative US earnings growth, after a 2% decline in Q4 2022. Current analyst expectations imply a worsening growth rate in Q2 (-6%) before flattening in Q3 (-0.5%) and returning to positive growth (+7%) in Q4.

US EARNINGS FORECASTS COULD FALL FURTHER

According to Bloomberg, the 12-month earnings decline from the most recent peak (in Q3 2022) to the expected trough (in Q3 2023) is forecast to be a 3% contraction. This would be very mild compared to historical recessions in the past 50 years, where the average US earnings contraction has been around 30%, according to Citigroup. Indeed, following the Global Financial Crisis of 2008, US earnings contracted by around 50%. However, we don't expect something of this magnitude. During the Covid pandemic, thanks to massive government stimulus, US corporate earnings only fell 14%.

This indicates that US earnings forecasts still have further to fall, especially in the event of a US recession. This could present a risk to equity market returns.

SECTION 4:
OUR PORTFOLIO POSITIONING

POSITIVE BIAS TOWARDS GOVERNMENT BONDS

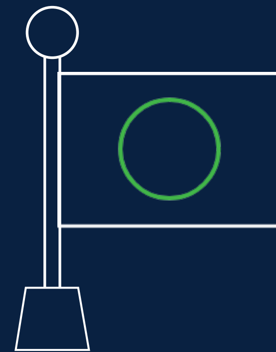
Our portfolios are positioned conservatively, with a modest tilt away from risk assets and a positive bias towards government bonds. Deteriorating macroeconomic data, inverted yield curve and systemic risks are all reasons to be cautious. The outlook for company earnings remains uncertain and recent US bank sector events will see further tightening in credit conditions.

GLOBAL HEALTHCARE ALLOCATION

Against this backdrop, we continue to run an allocation in global healthcare, given the sector's defensive nature and relative resilience in both recessionary and high interest rate environments.

CAUTIOUS SENTIMENT TOWARDS EQUITIES

We're also mindful of the cautious sentiment towards equities and the extent to which certain assets may already have discounted a fair amount of bad news. Emerging market regions have reached cheap valuations, exhibiting signs of stabilisation and economic recovery helped by China's economy re-opening. We added to emerging market equities this year and portfolios show a preference for the region over developed market equities. Furthermore, emerging market equities perform relatively well when the US dollar depreciates, which we see as a long-term trend even if a US recession could lead to a temporary rise for the US dollar.



MOVE AWAY FROM JAPANESE BONDS

We added to government bonds as signs of recession grew and the rate hike cycle draws to a close. Fading inflationary pressures saw these bonds provide stability in portfolios during the volatile period in March. Our positioning favours US Treasuries where interest rates are peaking and shies away from Japanese government bonds where there are tail risks associated with a potential shift away from easy monetary policy.

EMERGING MARKET DEBT

Although bond yield levels are more attractive, the additional yield on investment grade credit is modest in light of recessionary risks, and our client portfolios and funds hold some diversification into short-dated emerging market debt. We sold out of our financial credit allocation as the increasing recession risk and monetary tightening is not a supportive environment for high yielding bonds that usually exhibit higher volatility.

2030 NET-ZERO TARGET ON TRACK

Net zero in portfolios: Coutts continues to progress on its journey toward 2050 net-zero carbon emissions. Currently, average portfolio alignment against this ambition is 58% across our core investment propositions. This is ahead of our 2025 target and well on track to our 2030 target.

IMPORTANT INFORMATION

The value of investments can go down as well as up.
Capital at risk. You must borrow or invest more than £1 million with Coutts to become a client.
Eligibility criteria, fees and charges apply.

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