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Q1 outlook: False dawn?

We worry that hopes of a 'soft landing' for the world economy will prove ephemeral, so have adopted a modestly negative overall stance on risk assets.

Emiel van den Heiligenberg
Head of Asset Allocation

Given the torrid performance of most asset classes in 2022, we titled our Q4 outlook "it's darkest before dawn". From the positive tone with which 2023 has started, many investors appear to believe that the warm light of day is about to shine across markets. We disagree.

Like much of 2022, investors are continuing to focus on the inflation outlook and its implications for monetary policy. But a series of data releases have stoked hopes that the light at the end of the inflationary tunnel could be approaching.

This has raised expectations that recession may be avoided, with consumers receiving a much-needed boost from falling commodity prices that, in turn, would alleviate pressure on wages.

We worry that hopes of a 'soft landing' for the world economy will prove ephemeral, as Tim and James note in this report. Aggressive rate-hiking cycles almost always ends in recession, as credit conditions become tighter, while households and companies retrench from spending on housing, durable goods and capex.

Bearish posture

As a result, our overall stance on risk assets is modestly negative: we remain underweight both credit and equities. We are less concerned about duration, though, looking for nominal and real government bond yields to drift lower after shooting higher in 2022. (For more on our equity and fixed income views, see the pieces by Chris and Lars below.)

The repricing of real yields over the last 12 months wrought a profound change in the investment landscape, which should offer some respite to assets that have been punished during this process. For example, we believe the fortunes of infrastructure and property assets should be dictated by the fundamentals, rather than discounting.

We do not share other investors' optimism for commodities in the near term. Though the cyclical outlook for China might improve in 2023, we believe the rebound in growth will be less commodity-intensive than in previous periods – and structural headwinds remain. These risks need to be viewed against a background of ongoing tensions between China and the US, in our view.

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Special FX

Another key feature of 2022 was the relentless US dollar bull market, which only started to fade in late 2022. This was driven by the Fed's rapid tightening of policy, rather than interest rate differentials between countries.

Central banks elsewhere were also forced into hiking interest rates – albeit often hesitantly – because of rising inflation and to stop excessive weakness in their own currencies. Markets do not reward currencies whose central banks are reactive.

Most central banks now admit they have an inflation problem. Their action to curb rising prices will likely last longer than the tightening cycle in the US.

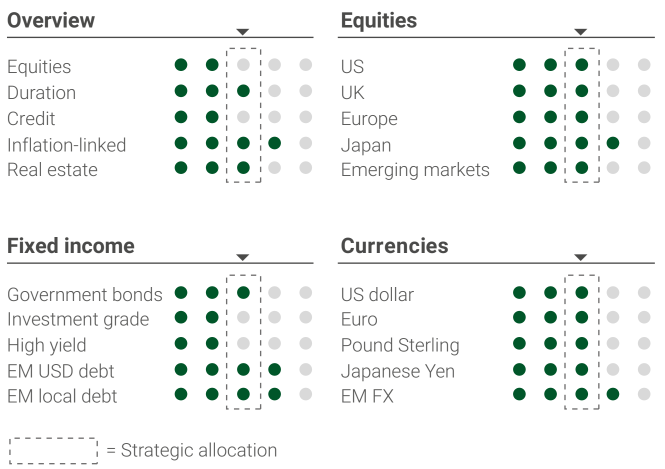
We believe this change in behaviour will restore interest rate differentials as the most important driver of exchange rates – and act as a headwind to the US dollar in 2023.

Signposts for a shift

All of this said, we would adopt a more positive posture towards risk assets in the event our economists begin to expect a soft landing – or at least push their forecast for recession to 2024. An end to the Russia-Ukraine war, sparking further declines in energy markets, would also prompt us to shift our stance.

Without these catalysts, we believe investors have begun 2023 by welcoming a false dawn for markets.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 13 January 2023. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Our core asset allocation view

Economic cycle

Baseline recession view for 2023. Central banks willing to move rates to be restrictive

Valuations & Sentiment

Relative valuations remain attractive and sentiment is still weak

Systemic risk

Unwind in the existential & systemic fears. Credit conditions deteriorating

Source: LGIM. Views current as at 13 January 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Economic cycle

- US is likely to be very late cycle and on the cusp of recession
- Central banks committed to moving rates into restrictive territory
- Fiscal support is coming, but adding to pressure on monetary policy

Valuations & sentiment

- Sentiment indicators have moved to be less bearish
- Relative valuations are no longer the natural bullish support for equities
- Absolute valuations have increased moderately

Systemic risk

- The war in Ukraine grinds on, but the market's focus is on growth / inflation
- Unwind in the existential / systemic fears from the start of the conflict
- Credit conditions and housing market more vulnerable with higher rate

Economics: When will central banks cease tightening?

Tim Drayson
Head of Economics

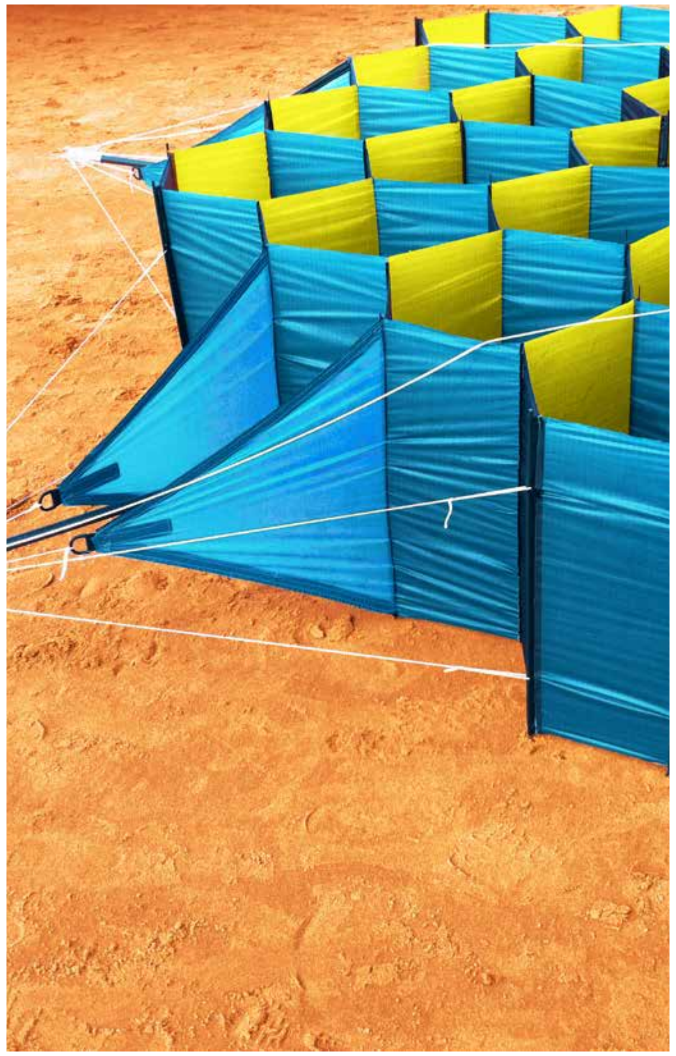
James Carrick
Global Economist

Prospects for the global economy are mixed, at best, this year: While the US should follow the UK and Europe into recession, we expect China to bounce back after scrapping its zero-COVID policy.

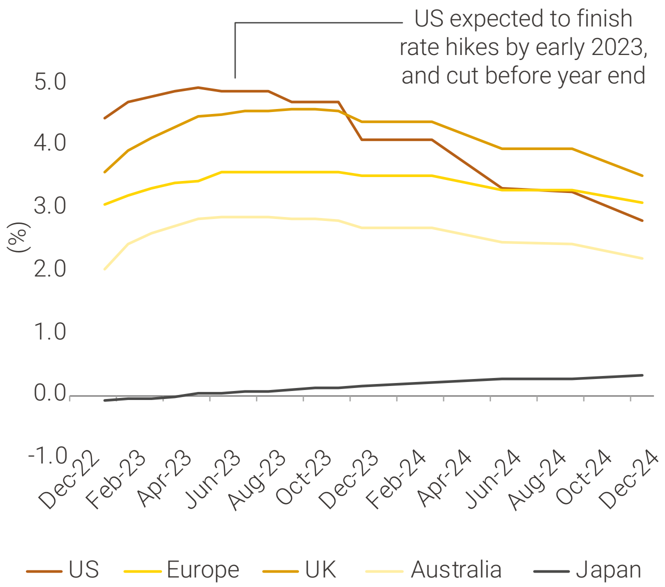
Over the past few years, the global economy overheated. Fiscal and monetary policy support were lavish during the pandemic, pushing up demand. But supply was reduced – both in labour markets (due to early retirement, reduced migration, school closures and self-isolation) and energy markets, particularly following Russia's invasion of Ukraine.

This resulted in excessive inflation and, in turn, aggressive monetary tightening. With commercial banks beginning to tighten credit availability, we appear set for recession. Official US GDP data have been volatile, but the underlying details and survey data point to a loss of momentum. The housing market is dropping, consumers are burning through their excess savings and corporate fundamentals are deteriorating.

Given elevated job vacancies, there is considerable uncertainty as to how long it will take for unemployment to rise. However, we expect recession to begin in the spring and for output to fall throughout the rest of 2023. Unlike last year, market participants are close to pricing in enough additional hikes for the Fed; we also see the prospect for rate cuts towards the end of the year.



Implied regional interest rates



Source: LGIM, Bloomberg as at 6 January 2023. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

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Sticky inflation

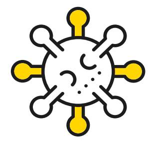
The situation is worse in Europe and the UK, where the energy supply shock is most acute and worse than similar crises experienced in the 1970s. Not only are real incomes being squeezed, but central banks are also tightening forcefully to limit second-round effects.

The UK has also suffered from policy blunders. These have resulted in market pressure forcing the government to deliver tighter fiscal policy than would have otherwise been necessary. More positively, a mild winter has dampened the energy price shock, though the outlook remains uncertain.

Another welcome development is that supply-chain disruptions – which led to a surge in goods price inflation in 2022 – are rapidly improving, aided by cooling demand. Service-sector inflation will likely prove much stickier, in our view, but recession and rising unemployment should reduce wage pressures as the year unfolds. The extent of rate cuts by central banks later this year and into 2024 will likely hinge on whether core inflation can make it all the way back to target or if it settles at a still somewhat uncomfortable level.

Meanwhile, the outlook for China is much better following the abandonment of its zero-COVID policy. The economy suffered a significant setback in the last quarter of 2022, but we expect a rapid rebound this quarter as its COVID wave peaks. Recent policy initiatives for the property sector also seem to be a gamechanger. These should allow the property market to bounce back to health, without triggering another unsustainable boom.

We expect strong growth in China, despite challenges

↑ 

Covid-19

Covid reopening has been interpreted positively by investors

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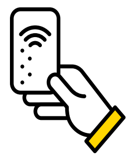
Property Sector

Recent flurry of measures announced that go to the heart of the property sector problem

↓ 

Tech Regulation

Regulation on tech expected to stay firm

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Geopolitics

Increasing tensions across the Taiwan Strait

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Fixed income: Questioning the consensus

Christopher Jeffery
Head of Rates & Inflation Strategy

For most fixed income investors, 2022 was a year to forget. The Bloomberg Global Bond Aggregate* Index fell 11%, with negative returns in 10 out of 12 months during the year.

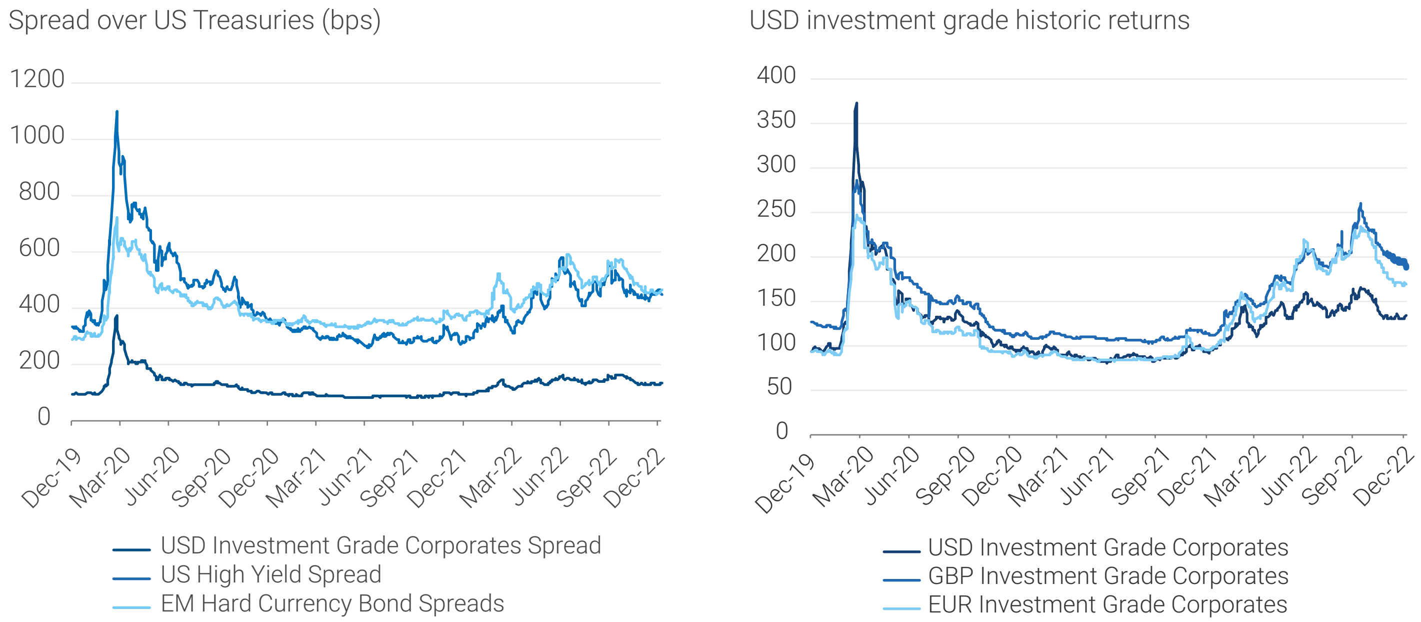
Bond returns suffered from multiple angles: rising sovereign yields driven by relentlessly hawkish central banks and widening credit spreads, as fears of a recession-driven default cycle took hold.

Looking back on last year, it is worth reflecting on how far the narrative evolved, with the Eurozone offering the most dramatic pivot. Christine Lagarde, European Central Bank (ECB) President, told markets in November 2021 that any rate hikes in 2022 were "very unlikely".

Inflation at generational highs clearly steamrollered these plans – and those of other central bankers. In reality, the ECB raised rates by 250bps over the second half of the year and promised multiple rounds of additional hikes in the months ahead.

For investors, the inflation surge has not only delivered stinging losses on fixed income assets, it has upended the correlation between bonds and equities to the detriment of portfolio diversification.

Credit spreads still have room to widen



Source: LGIM, Bloomberg, Bloomberg Barclays US Aggregate Corporate Excess Return, as at 3 January 2023. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Govvies vs credit

Looking ahead, it's a consensus statement to say that the worst is likely over for fixed income. The case for a rebound – or at least an end to the negative spiral – is based on the following rationale:

- Negative-yielding debt has almost entirely been confined to the scrapheap
- Credit spreads once again offer reasonable compensation for downgrade and default risk, in our view
- Most fixed income asset classes now offer an enticing yield

This argument sounds convincing and is not necessarily wrong. In particular, we are less worried on the prospects for nominal and, in particular, inflation-linked sovereign bonds than at the start of last year.

However, we still harbour concerns that credit spreads have not yet been tested in this cycle by the earnings write-downs and the corporate restructurings that are set to follow. So far, the greatest earnings pressure has come through in mega-cap tech – the sector with the strongest balance sheets.

The rising share of BB rated debt within high yield indices points to a steady drift higher in credit quality, with more marginal borrowers consigned to the loans market. Unfortunately, that has been matched by the rising share of BBB debt within investment grade indices. We worry this leaves investment grade credit unusually vulnerable to a recession, particularly in the US market where the starting point for spreads is much tighter than on the other side of the Atlantic.

* Hedged in USD, as at 31 December 2022

Equities: More pain, then gain?

Lars Kreckel
Global Equity Strategist

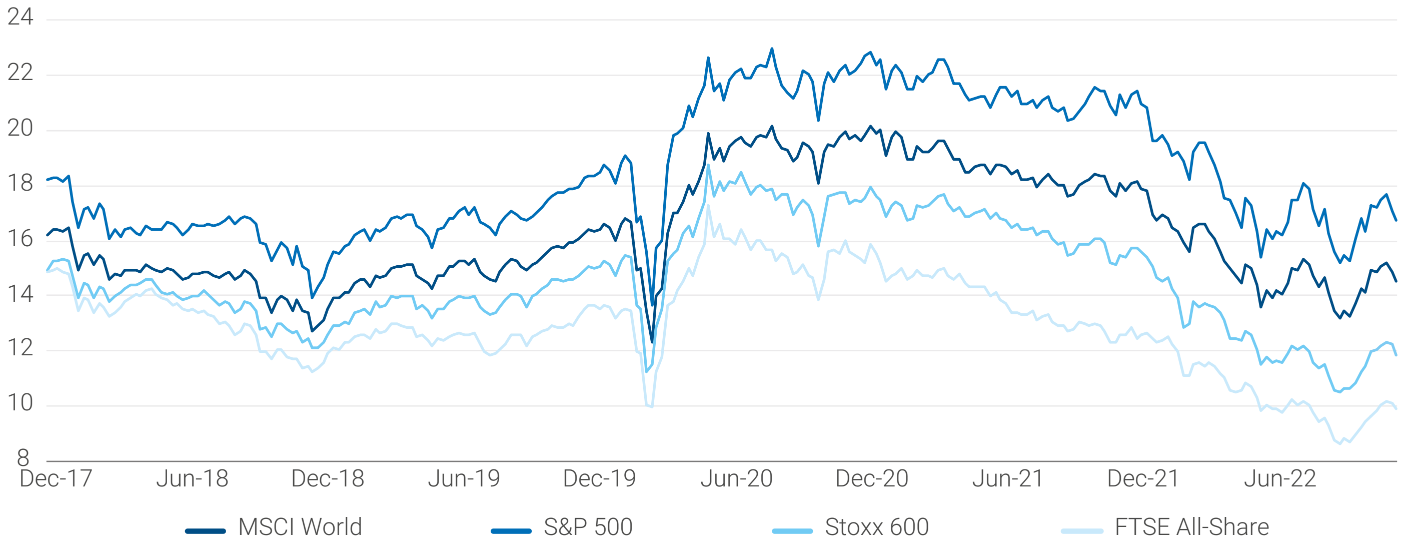
We fear 2023 will be another difficult year for equity markets – at least initially – given the economic backdrop outlined by Tim and James.

What's more, as stocks have rallied from the troughs of 2022, and with investor sentiment no longer extremely bearish, we see risks skewed to the downside. Should the mild recession anticipated by our economists play out, we would expect equities to make new bear-market lows.

While some recession risk is priced in, we attribute the majority of last year's drawdown to a de-rating driven by the sharp rise in interest rates. As we head into 2023, we anticipate the focus to shift from ever-higher central bank rates towards recession, which we expect to go from being a distant threat on the horizon to an immediate reality for investors, evident in hard data, such as earnings.

Equity valuations have softened

Equity index forward P/E ratios



Source: LGIM, Bloomberg as at 13 January 2023. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

In terms of corporate profits, our economic base case is consistent with a 20-25% peak-to-trough decline in S&P 500 earnings. From today's levels, this would be difficult for the stock market to shrug off.

Ultimately, we expect equities to bottom out before the recession ends. Fundamentally, in our view, that moment will only come once visibility on the economic trough – and thus the earnings trough – improves. According to data from 1933 onwards, US equities have bottomed on average five months before the end of the recession. All of this suggests a new bull cycle could begin around the autumn of this year.

Backing Japan

Our current macro views on the cycle give us reason to believe that equities should be able to anticipate and price in an economic recovery at some point in 2023. But from today's perspective, this prospect seems too distant and uncertain to expect the current bear market to have already run its course.

Within equities we harbour particular concerns about the most cyclically exposed sectors. These have held up unusually well so far.

As the focus turns from "recession is coming" to "recession is here", we expect a lot more rotation within equities. Regionally, Japan is our preferred market, given the desynchronised nature of its recovery and benefits from recent fiscal stimulus.

At the sectoral level, we think tech stocks are set to have a better year, with their earnings likely to prove more resilient in a global downturn. Within tech, we see potential in Artificial Intelligence. In terms of thematic plays, we believe decarbonisation will remain the most important secular investment theme.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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