DLS CAPITAL MANAGEMENT

PORTFOLIO POSITIONING FOR 2023 – SOME THOUGHTS

Graham O'Neill - DIRECTOR AT INDEPENDENT RESEARCH CONSULTANCY LIMITED

We are clearly now in a new macroeconomic regime (see April 2022 Outlook Regime Change Rules the World). The era of low inflation, low interest rates and low macroeconomic volatility is over, for now at least. Recent comments over the past week including likely upgrades to economic forecasts by the IMF only reinforce this view. In this new regime, whilst interest rates will naturally fluctuate, they will not return to zero or ultra-low levels. Tighter monetary policy (higher short-term interest rates) is not temporary and the easy monetary era is over. All risk assets valuations will need to adjust to permanently and structurally higher cash rates. In other words they will need to offer sufficiently high risk premia over short-term interest rates to be attractive. Whilst listed (stock market quoted) asset classes have adjusted to a significant extent, many unlisted valuations have yet to reflect this new reality.

A structurally higher level of interest rates and greater macroeconomic volatility will place a valuation constraint on equities in terms of justifiable PE ratios and on bonds in terms of the level of 10 year yields. This is likely to make meeting the required returns by investors through market moves alone (beta) much harder to achieve. As a result investors need to place a greater emphasis on generating additional returns from active management known as alpha generation. Whilst this is difficult to source with confidence, more volatile macro conditions produce greater dispersion in return so hence more alpha opportunities. It might be best for investors to focus when looking for alpha opportunities in less efficient markets which historically have seen a greater propensity for active managers to outperform.

This increased emphasis on alpha generation needs to be quite granular, encompassing regional and sector allocation in equities, duration and credit exposure in bonds, and currency pairs management as well as inter asset class allocation. If macroeconomic volatility is higher there may be a need to manage these positions more dynamically and in 2023 there remain a range of possible macroeconomic and geopolitical outcomes, none of which can be predicted with any high degree of certainty.

In terms of economic outcomes, what happens in the US will as always be a major influence on markets globally. Here there remain three potential outcomes: namely a soft landing, a hard landing or stagflation in some form. Under the first of these, the Fed has already done nearly enough in terms of rate rises giving scope for interest rates to be cut by the end of 2023, with only a mild economic contraction and inflation falling to 2%. Under a hard landing, the Fed will need to continue to tighten policy to ensure enough economic weakness occurs to lower demand, especially in the employment market, reducing upward pressure on wages to return to a sustainable 2% inflation rate which remains its published target. Under a stagflationary scenario (the exact definition of this varies) the Fed initially pauses rate rises and as economic activity weakens eases policy in the belief the economy is returning to its 2% inflation target, but when inflation proves sticky and starts to rebound later this year or early 2024 renewed monetary tightening is required. This is what occurred in the 1970s and much of the 1980s.

Investor expectations will oscillate between these outcomes. In the earlier part of 2023, economic releases are likely to support the soft landing scenario, i.e. the inflation rate will continue to decline driven initially by the collapse in goods prices and later by the fall in the US housing component of CPI. Economic activity will also moderate. This has favourable implications for interest rates and the market is likely to front run this and has already seen a rally on the expectation that the Fed will end its tightening relatively soon and this will ease concerns over a prolonged recession or downturn. However, the Fed cannot afford to ease prematurely and in fact J Powell in his May Fed press conference and subsequent Q&A session seemed to emphasise this when he talked of his admiration for Paul Volcker and it seems unlikely Powell wants to repeat the mistakes of the 1970s and become the next Arthur Burns. Thus in reality, an early ‘pivot’ remains unlikely and rates are likely to remain at high (restrictive) levels and during the middle part of the year fears of a recession could become a more dominant influence. There is every possibility that by year end the narrative will have changed again and once the Fed does change course expectations of an economic recovery will take hold and markets if following the pattern of recent years are likely to latch onto this at a much earlier stage than has occurred in previous economic cycles. Whilst early monetary easing would be welcomed by the markets, the third possible outcome, stagflation, would become more likely if the Fed through political pressure cut rates in the face of rising unemployment and weaker economic activity whilst inflation was still above target levels. A pickup in inflation once again forcing the Fed to reverse track would be viewed poorly by markets. From a timing perspective the greater risk of this politically influenced outcome is probably not this year, but in 2024 a Presidential Election Year.

Geopolitical events will continue to be an important market influence. An end to the Russia/Ukraine war, or at least a cessation of hostilities remains possible and would have a positive impact on sentiment generally, especially for European markets, commodities and energy. New Covid variants are continuing to appear and need to be watched closely and the possibility of a mutation to a more virulent form cannot be entirely ruled out.

There are three other key macro developments that need to be reflected in portfolio positioning. China’s Covid relaxation, its easing of property restrictions and its more relaxed attitude to big technology are a big deal not just for China’s growth, but for emerging markets more broadly and commodity demand. China’s growth rebound had global implications in 2009 and this may well be the case in 2023. The US$ has peaked and is now in a downtrend. This is likely to be further reinforced by a change in the Bank of Japan’s yield curve control policy post the retirement of BOJ Chief Kuroda in April which will encourage further capital flows to Japan causing the Yen to strengthen.

SUMMARY

There remain widely differing views amongst leading strategists of how economies and markets will perform in 2023. In fact, the range of outcomes by respected market commentators have probably never been wider. Overall, the consensus view entering 2023 was for equities to be weaker in the first half of the year followed by a stronger performance in the second half. The dangers of following a strong consensus were never better demonstrated than in 2023 and this consensus view is different to the pattern suggested above, where initially the early months of the year might turn out to be stronger with a likely upgrading of economic forecasts as a time of falling headline inflation rates, meaning the line of least resistance for the stock market may be up. For many institutional investors the pain trade today is for stronger equities. Once the easy gains in inflation have taken place, primarily through lower goods prices and easing supply chain bottlenecks investors may focus on whether inflation will fall back to central bank target rates resulting in another period of equity market weakness. By year end there is likely to be sufficient clarity on what central bank policy will be and the level of peak rates, the length and extent of a downturn with a rebasing of earnings estimates and early investor anticipation of the next economic upswing. Within this, the regime shift that has occurred with a move to structurally higher interest rates than have prevailed in the post GFC period means markets will continue to trade at lower valuation levels than the past decade so will need earnings growth to reach new highs. Without significant rate cuts the scope for meaningful capital gains in government bonds would appear muted. The eventual driver of markets to new highs will need to be earnings growth rather than multiple expansion as higher interest rates will keep a lid on market valuations.

G O'Neill 23.01.23

GRAHAM O'NEILL

Director at Independent Research Consultancy Limited

Graham is an investment researcher of international note and has been working in this area for over 20 years. He began his career in the stock broking industry before becoming an institutional fund manager where he practiced both in Ireland and the UK where he worked in senior roles with a number of institutions including Royal Life holdings, Guardian Royal Exchange and Abbey Life.

Throughout his career, he has managed multi-million Euro funds and developed innovative investment fund concepts. Seeing the need for non biased, critical analysis of the investment industry, Graham began work as an independent investment researcher in 1992 and since then, principally, he has provided services to financial institutions. Graham is also a director of RSM Group, a leading UK investment research company.

Through his research process, Graham filters through the broad range of Irish and International investment fund managers for those investment managers who consistently perform best.

He conducts in the region of 150 teleconference meetings and on site interviews with asset managers in UK, Europe, China, Hong Kong, Singapore and Australia. Following on from these meetings, Graham produces detailed research notes.