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Q4 CIO Outlook: September 2023

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Elaine: Anthony and Lenny, the last time you were both on a webinar was in June and quite a bit has happened since then. Lenny, could you give us an update?

Lenny: Both equities and bonds are actually down slightly in Q3. It's been more mixed for equities in that they started the quarter quite strong and have been soft in the last three or four weeks. The strength in equity markets at the start of Q3 was due to an increasing belief that we're going to get a soft landing in the US and the global economy. This was driven by the strong consumer backdrop and very robust investment in the US economy due to the CHIPS Act related to semiconductors and the Inflation Reduction Act for energy and climate-related initiatives.

Equity markets have come off recently as bond yields have ground higher, with central banks suggesting that rates will have to stay higher for longer amid sticky inflation. Headline inflation globally in August was about 50 basis points (bps) month-on-month (4.5% year-on-year). That was the highest month-on-month figure since January of this year. The US Treasury also indicated that it was going to increase the issuance of Treasuries through the remainder of the year from about $720bn to $1 trillion and that also added to upward pressure on bond yields.

In terms of the outlook, we think the setback that we've seen in equities does offer an opportunity for people to begin to consider buying equities here. PE multiples are now trading below long-term averages – global equities are at a P/E of 15.7 versus a long-term average of 16. In a soft-landing environment, we think earnings can grow by 10-11% in 2024 compared to flat this year.

In relation to bonds, we think bond yields will be lower over the next 12 months since we're at or very close to the peak of policy rates among global central banks and that should lead to lower bond yields over the course of the next 12 months. We also expect inflation to continue falling, and growth, while it will remain positive next year, will probably be a little bit lower compared to this year.

Elaine: Anthony, can you take a bit of a deeper dive and help us understand the sea change in policy that Lenny has alluded to and what it might mean for investors

Anthony: We believe investors globally are facing a new regime across the policy, macro and geopolitical landscape.

We see three structural changes on the horizon or currently happening that will critically shape the investment outlook going forward:

1) The end of the era of 'free money' – in the form of a normalisation in policy rates and a reduction in balance sheets which have buoyed markets – may make returns harder to generate from here;
2) Reduced globalisation and increased protectionism, resulting in greater geopolitical tensions and higher inflation as supply chains are redrawn;
3) Central banks are focused on stemming inflation and, therefore, this will limit their ability to loosen policy aggressively to counter market volatility or downturns in the business cycle.

For investors, this new regime means a more multipolar world and, with that, comes greater volatility both on the downside and potentially on the upside. Within our portfolios, we're very mindful in terms of developing smart, defensive strategies, so that means looking at smart ways of diversifying our portfolios while also incorporating risk management strategies to protect against increased potential downside.

On the upside, we believe investors need to be more selective in terms of return opportunities given greater dispersion and dislocation across assets. The 'golden era' for asset owners, where QE benefited all risk assets, just isn't there for the near future.

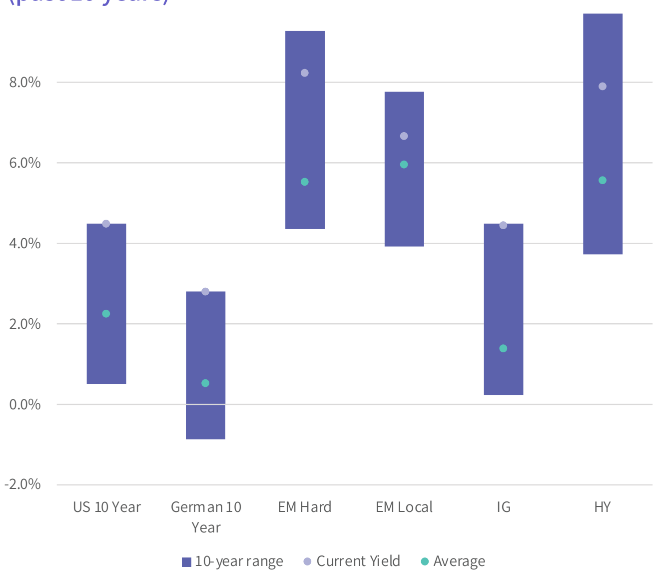
Elaine: You mentioned opportunity there a number of times and it is a changing environment, so Lenny, looking at fixed income, where are we seeing any opportunities?

Lenny: Something we've been saying internally is that 'bonds are back'. After the most aggressive tightening cycle in 40 years, bond yields have risen significantly to levels we haven't seen in 10-16 years across the various fixed-income asset categories (Chart 1). Notably, German 10-year yields are now 2.8%, the highest since 2011; eurozone IG yields, at 4.5%, are the highest since the eurozone debt crisis, and EM hard debt and global high yield are both yielding just over 8%. We think bonds now represent an opportunity to investors for two reasons. One is the level of carry, or income stream, you're getting from bonds; and two, at these higher yield levels, bonds now can fulfil that traditional hedge protection within a portfolio, which they were unable to do when yields had fallen to extremely low levels. Overall, both short- and medium-term, we see bonds as playing a key role within portfolios and offering you a real alternative now for diversification.

Anthony: Within our multi-asset portfolios, we now see an opportunity across bond markets to add income at attractive levels, but at the same time benefitting from the diversification offered by fixed income. Also, we have been assisting our Defined Benefit investors review their liability matching portfolios, given the income and matching opportunity set that is currently available.

CHART 1

Yield across fixed income sectors (past 10 years)



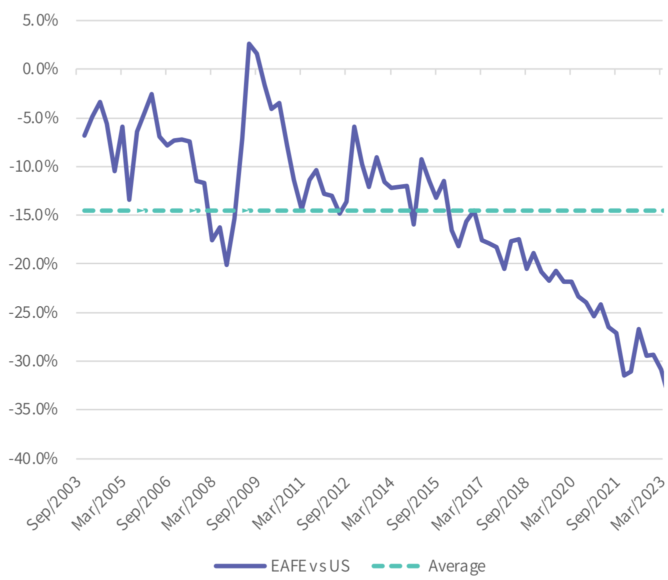
As at 25 September 2023

Elaine: Looking at equity markets, where do you see opportunities across different regions?

Lenny: In terms of equities, on a five-to-10 year view, we're expecting returns of just over 6% per annum, so quite strong returns. Within equities, there are two regions or categories that stand out to us. One is EAFE equities – global equities ex-North America – and the second is small caps. The reason both stand out is due to underperformance recently and attractive relative valuations (Chart 2). EAFE equities typically trade at a discount of about 14% versus US equities, but that discount is currently about 34%, so they look extremely cheap. It is a similar case for small cap equities, which usually trade at a premium to global equities of some 16%, but are currently trading at an 8% discount. Falling inflation that remains elevated would lend itself to higher levels of nominal growth going forward and this should support both EAFE and small cap equities over the next few years.

CHART 2

EAFE vs. USA: relative forward P/E



Small cap vs. world: relative PE (next 12 months)

Source: FactSet/MSCI. Returns are in local terms. Data to 30 June 2023

Elaine: **Anthony, we've seen quite a build-up of cash and cash-like assets. For clients considering timing or which opportunities they should be looking at, what are your thoughts?**

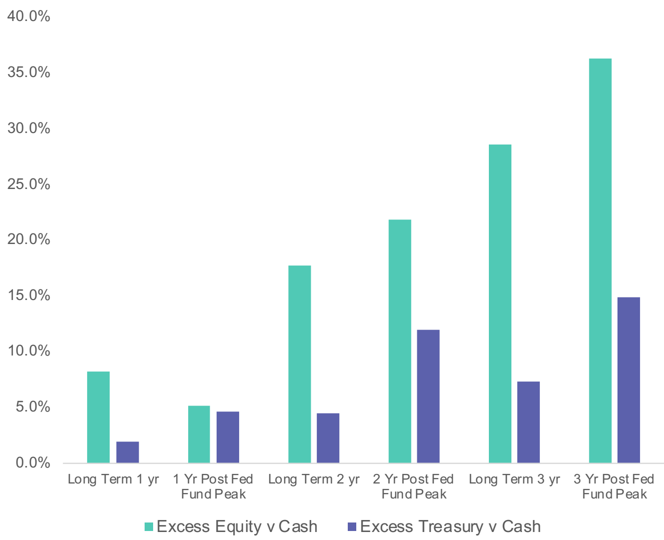
Anthony: This is something we've been actively looking at and working with clients on. We've been speaking to investors about the coming inflection point in the hiking cycle and the attractive longer-term rates that are currently available.

We studied asset class returns across fixed income and equities versus cash at the point where we reach peak policy rates. What we see in all environments is that holding equities or bonds versus cash is typically an outperforming strategy over the long run (Chart 3). In particular, at those points where you see a turn in the interest rate policy from central banks, you tend to see both equities and fixed income outperform cash more strongly than in the typical average environment, with equities outperforming fixed income over a 2-3 year holding period. Cash has a place in the portfolio, but it is not an investment portfolio strategy in its own right.

Overall, this calls out the strong rationale for staying invested in markets at this point. Also, we emphasise the importance of staying diversified across markets and opportunities at this point in the cycle. I think recognising that we're at a point of change in terms of the investment landscape and macro backdrop points to new opportunities, some of which we've discussed today.

CHART 3

Average long term cumulative asset returns



Source: Bloomberg/ILIM. Returns are in local terms. Data to 31 July 2023

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