PACIFIC
ASSET MANAGEMENT

PACIFIC MULTI-ASSET SOLUTIONS

INVESTMENT OUTLOOK

2023: 1st Quarter Insights

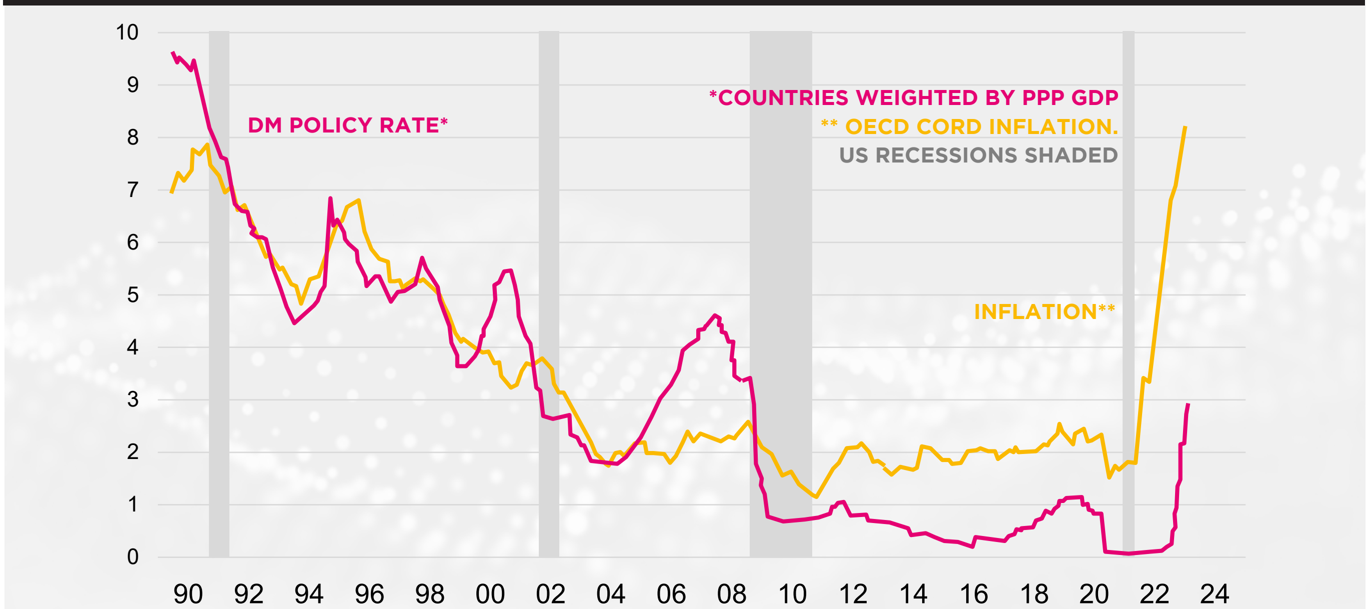
OUTLOOK SNAPSHOT: (Estimated reading time 60 seconds)

- It was important to remain diversified, tactical and build inflation resilience into portfolios in 2022, and we think the story will be similar for 2023.
- However, the asset classes and tools that we use to achieve these three aims might shift, as market volatility has thrown up opportunities after the tumult of 2022.
- Opportunities exist in inflation linked bonds, value stocks and non-US equity markets, as well as within alternatives and diversifying assets.

OUTLOOK: (Estimated reading time 6 minutes)

2022 will go down as one of the most challenging years investors have faced. Accelerating and broadening inflationary pressures forced central banks to act rapidly and in near unison, despite the causes of this inflation being different in different geographies. Initially, supply constraints pushed up goods inflation in many developed markets, but this soon broadened out into price pressures for services and into wage growth across developed markets, particularly the US. For Europe and the UK, the Russian invasion of Ukraine caused immense pressure on Energy markets, creating supply side inflation as the price of electricity production moved sharply higher.

Developed Economy Interest Rate and Core Inflation



Source: OCED, IMF, Bloomberg, NIBER, Minack Advisors

There are three key three pillars to our process that were important in navigating 2022, but also that we believe will be critical for investing in 2023:

I. Diversification
II. Tactical Asset Allocation
III. Building inflation resilience into portfolios

Diversification

Its role in 2022

Diversification was critical in 2022, when both equity and fixed income markets fell in tandem. Over the year, PAM's allocations to Alternatives and Diversifying Assets provided useful diversification benefits.

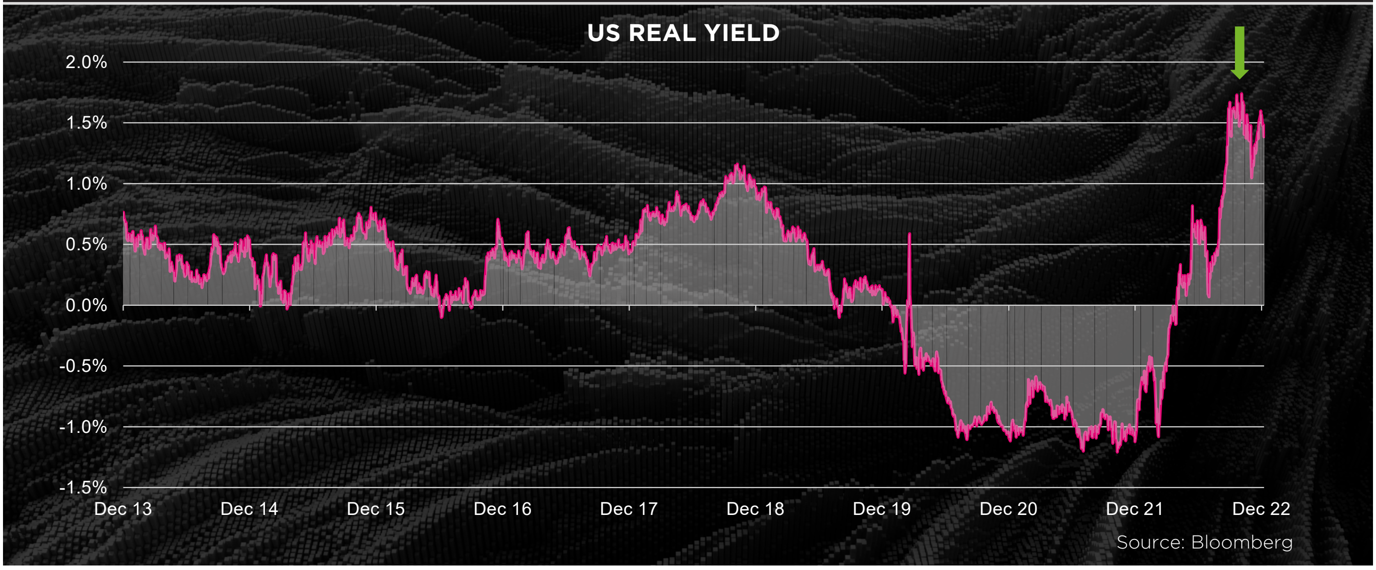
We consider Alternative assets to be commodities, gold as well as infrastructure and listed commercial property. Many of these asset classes, including electricity generating infrastructure performed well and were an important source of diversification for portfolios in 2022.

Diversifying assets exposure comprises macro strategies, risk premia, and other strategies that are uncorrelated to equities and bonds. Strategies that utilised momentum were positive, as they capitalised on heightened macroeconomic volatility. A strategy that takes advantage of the dislocation between value equities and growth equities performed strongly over the year, up nearly 25%.

Diversification in 2023

Last year, bonds and equities were falling simultaneously leaving no place to hide for portfolios lacking exposure to alternatives and diversifying assets. In fact, this was the worst year for a 60/40 portfolio of equities and bonds since 1937. This year however, we think that the positive correlation between equities and fixed income may recede, paving the way for more tools to diversify if growth does slow. We have therefore added an allocation to inflation linked bonds, whilst remaining cautious on economically sensitive fixed income such as High Yield.

US Tips Real Yields - Last 10 Years



We still believe our allocations in both diversifying assets and alternatives have scope to perform strongly in 2023, as markets continue to be volatile, with opportunities for us to add uncorrelated return drivers to portfolios outside of conventional assets.

Tactical Asset Allocation

Its role in 2022

2022 was a year for tactical asset allocation: although markets fell over the year, there were a number of sharp bounces in equity markets, including the current rally that has continued into the new year. It was a year where it was important to be active in our equity positioning. Much of the selloff in equities over the year was driven by financial tightening conditions, a result of developed market central bank policies, but as with many bear markets there were a series of sharp rallies as markets reassessed the likelihood for a growth slowdown and digested central bank speak. We were reactive to these rallies short term, adding to risk assets, but with the view that the medium-term trend for markets was lower.

In addition, although most markets fell, there were some regions that were more resilient, including large cap UK companies where we tilted our portfolios. These companies are global in nature (and were therefore less exposed to UK domestic growth concerns), and trade at a valuation discount to global peers. The UK index ended flat at the end of the year, a very strong result versus other markets.

Tactical Asset Allocation in 2023

Looking ahead, we expect market volatility to continue to be elevated and it will be necessary to respond rapidly to an uncertain and fast evolving market environment in 2023. We also expect that regional positioning will be a key driver of performance, as ex-US equities appear better placed than their US counterparts. Europe, UK and Emerging Markets are all more attractive from a valuation perspective. In the US however, valuations at an index level continue to be challenged, and do not reflect growing recession risks. Other tailwinds of the last decade, such as dollar strength are likely to become headwinds, with the dollar likely to continue to weaken as it remains well above fair value.

Inflation Resilience

Its role in 2022

Perhaps unsurprisingly, after years of ever lower inflation and interest rates, large pools of assets were invested in equities that had benefited from these extraordinary monetary conditions, namely growth stocks. Last year saw those strategies struggle as rising bond yields pushed down their valuations and some high-profile stocks came tumbling down to earth. The focus of the equities in our portfolios was towards the cheapest stocks – so called value stocks – and to companies that have a long track record of paying dividends – the Dividend Aristocrats.

We believed that both Value and Dividends would be resilient in an environment of both heightened inflation and interest rates. History teaches us that Value equities tend to outperform during periods of higher inflation, and furthermore, the valuation of these strategies was far lower than that of growth equities. On some measures, the spread between the cheapest and most expensive parts of the market was as wide as it was during the tech bubble of 2000. Companies that have a consistent record of paying dividends are well placed to weather an uncertain economic environment.

Inflation in 2023

We think that the worst of the inflationary pressures have passed in the short term for the global economy, as growth and inflation measures have started to roll over in many developed economies. However, history shows us it can often take several years for inflation to normalise following shocks such as those seen post-COVID, and our view, given the valuation disparity in markets is that value strategies remain attractive. Given this, and the concentration of indices such as the US in growth focussed companies, we also believe that there is opportunities for active management to outperform in 2023, after years of lacklustre returns.

CONCLUSION

We think that in 2023, many of the key themes that investors needed to focus on in 2022 will continue, but with a slightly different flavour. Diversification will remain crucial, but the asset classes that provide the best diversification may well change, as market pricing has moved a lot over the past year.

The Federal Reserve continues to keep monetary policy tight, the unemployment rate needs to rise in the US to stave-off inflationary pressures and to normalise wage pressures, but the headline unemployment rate has never risen by 0.5% without triggering a recession. It is possible that the Federal Reserve will pull off this trick, but history is against them.

The economic cycle in the post-COVID world has been rapidly changing, and therefore remaining tactical and adaptable will be vital to success in markets.

Finally, we expect that although headline inflation will cool this year, longer-term inflation is likely to be higher this decade than in the previous two. It is therefore important to have a portfolio that can weather a more volatile inflation backdrop.

PLEASE GET IN TOUCH

Pacific Asset Management
1 Portland Place
London, W1B 1PN
United Kingdom

Contact us
T +44 20 3970 3100
E info@pacificam.co.uk

www.pacificam.co.uk
For more information, updates and to find out more please visit our website

PACIFIC ASSET MANAGEMENT

> MOVE FORWARD