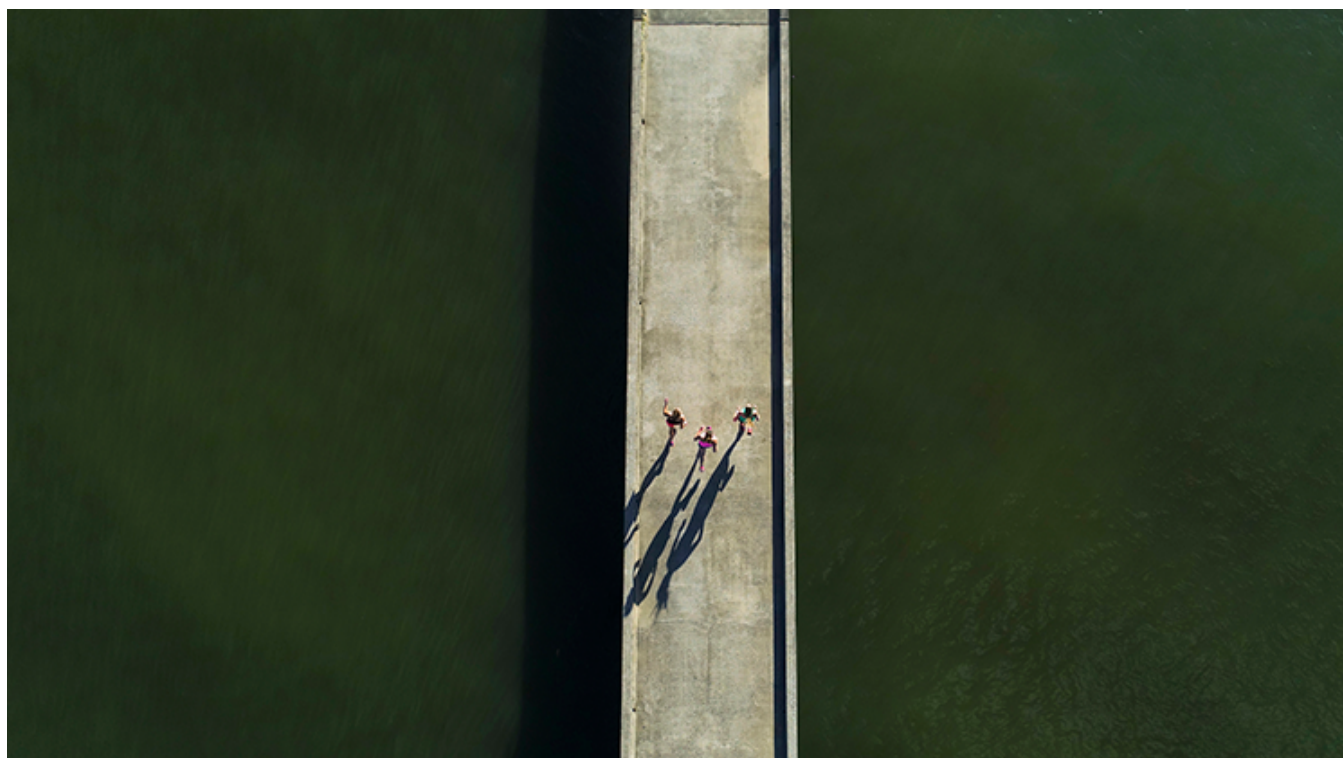


Three scenarios for investors to consider in 2023

By Michael O'Dea

9 March 2023



The likelihood of a synchronised global recession has moderated recently, but there remain significant risk factors that could catalyse a global downturn. Perpetual's Head of Multi-Asset,

Michael O’Dea, looks at three possible scenarios and their implications for portfolio construction.

Recent months have seen a transformation of the outlook for global growth with significant implications for portfolio construction. There have been several catalysts for improved investor sentiment and expectations, including:

- Europe has averted a severe recession that was widely expected just six months ago, owing to a warmer-than-average winter and a rapid recalibration of energy supplies.
- Growth prospects in China have been revised up on a combination of easing COVID restrictions, relaxed collateral and equity issuance standards in the property sector, stable inflation and stimulatory monetary policy.
- The US remains on a very narrow path to a soft landing, endorsed by lower inflation and a strong labour market.

Given the evolution of the global growth outlook, we have identified three scenarios for investors to consider in 2023:

1. Global Recession
2. US-centric recession and global resilience
3. Global soft landing

Global recession

The likelihood of a synchronised global recession has moderated recently, but there remain significant risk factors that could catalyse a global downturn. Most crucially, central banks may be forced to over tighten monetary policy by persistent inflation.

In the event of a global recession, we would expect to see monetary policy and liquidity conditions eventually ease, with the extent depending on how far inflation falls. However, rate cuts and the end of quantitative tightening would not save equity markets, which would be marked down on much weaker earnings and a likely fall in the PE rating of the market. It is important to note that in the two previous major bear markets, most - if not all - of the fall in US equities occurred after the first rate cut (in December 2000 and September 2007).

There is a precedent for US equities to outperform non-US equities during a global recession. They would likely be supported by better quality and a more responsive central bank – but this out-performance may be short-lived as the valuation disparity in favour of non-US equity markets remains large. We would expect the US dollar to be stronger in the near term, before entering a longer-term bear market from late 2023 or early 2024. Global bond returns would be positive – potentially very positive – depending on how far inflation falls and how central banks respond.

US-centric recession/global resilience

With the improved outlook for Europe and the reopening in China, the likelihood that the US enters recession while the global economy remains resilient has increased. Historical precedent suggests that US-centric recessions are far more common than globally synchronised recessions.

We would expect to see global liquidity conditions ease as the Fed is central banker to the world and this scenario would ease the pressure on emerging markets. How much would depend on the performance of the US Dollar. Narrower interest rate differentials suggest a weaker US dollar, but capital repatriation and risk aversion could lead to a substantial rise before a bear market sets in. Under this scenario, the equity bear market could still be very severe. For example, the bear market in 2000-02 where the US S&P 500 lost half its value in two-and-a-half years was associated with a very mild US recession (-0.3% over 8 months) and no global recession. Surprisingly, US equities could out-perform non-US equities in the near term, but this would likely present a great opportunity in non-US markets.

Global soft landing

The window for a global soft-landing scenario has widened somewhat as a result of Chinese reopening, the resilience of the European economy and falling energy costs. In this scenario, we would likely see the tightening of financial conditions intensify as central banks focus on combatting inflation and persist with quantitative tightening. An easing cycle of 75 to 100 bps in the US is possible plausible in early 2024 if US core inflation reaches the Fed's 2% target level.

However, there could be a significant risk that the fall in inflation is inadequate (as commodity prices including oil increase again) causing a prolonged period of 'tight' monetary policy and potentially further tightening later this year or early next year (after a pause). Consequently, this is still likely to be a challenging scenario for US equities, which is the market most sensitive to higher interest rates (through pressure on growth stock valuations).

Conclusion

Navigating these scenarios will provide a significant challenge for investors for an extended period. Positioning to defend capital through bear markets while participating in the rallies is a puzzle complicated by the opaque outlook. In the process of preparing our portfolios for these scenarios we have consistently looked to current valuations in order to identify where the most potentially resilient markets are. For example, a consistent theme throughout each scenario is the more attractive relative starting valuation of ex-US developed market equities. At the same time, we remain focused on identifying asymmetric opportunities with known or limited

downside risks. With an uncertain outlook and market sentiment able to shift quickly, risk management is paramount and remains at the core of what we do.

This information has been prepared by [Perpetual Investment Management Limited \(PIML\)](#) ABN 18 000 866 535, AFSL 234426. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. The information is believed to be accurate at the time of compilation and is provided in good faith. This document may contain information contributed by third parties. PIML does not warrant the accuracy or completeness of any information contributed by a third party. Forward looking statements and forecasts based on information available at the time of writing and may change without notice. No assurance is given that the forecast will prove to be accurate, as future events may impact actual results and these could differ materially from those anticipated. Any views expressed in this document are opinions of the author at the time of writing and do not constitute a recommendation to act.

The Product Disclosure Statement (PDS) for the relevant funds, issued by PIML, should be considered before deciding whether to acquire or hold units in the Fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au. No company in the Perpetual Group (Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. No allowance has been made for taxation and returns may differ due to different tax treatments. Past performance is not indicative of future performance.