2023 Outlook: Peaks and valleys

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Following 2022 which gave investors a rare experience of significant simultaneous drawdown in both equities and bonds, consensus seems to be prepared for more of the same in the year ahead. Our counter-consensus macro assumptions shape our relatively constructive investment convictions. Yet, in our view, 2023 investment landscape is defined by peaks and valleys – navigating which could still be challenging. This note provides the roadmap.

Slowing growth, persistent inflation, rising interest rates, elevated geopolitical risks have all caused acute volatility in financial markets during 2022. The macro scenario of stagflation defined as below-trend growth and above-trend inflation has become a consensus view amongst market participants. Consensus portfolio positioning has been extremely cautious too with significant overweight in cash and substantial underweight in equities and bonds. We challenge this consensus view for 2023 on two distinct levels. First, we believe that stagflation is unlikely to be the scenario that the global economy faces over the next 12 months. Second, even if stagflationary environment materializes, there is little value in aligning the positioning with consensus trades. In our view, peaks in inflation, interest rates, and the USD along with the valleys (troughs) in global growth, corporate earnings growth, and investor sentiment are all likely to influence market performances during 2023. We think 2023 is likely to be the year of active management with timing of these peak and valleys being very important. In our investment strategy section of the report (pages 2-5), we discuss this in detail. In our asset allocation, we are now overweight cash, and fixed income (upgraded from underweight); neutral equities; and underweight alternatives (downgraded from neutral). For our detailed portfolio positioning see pages 6-7.

Fixed income (pages 8-9): We upgrade fixed income to an overweight from underweight. Admitting that it is difficult, if not impossible, to predict the peak of the rates cycle, we still think 2023 is likely to be a positive year for fixed income assets after having faced one of the worst years on record in 2022. We are overweight USTs (7-10Y), neutral US and EU IG, and underweight US and EU HY. Within emerging markets, we stay neutral EM USD sovereigns, underweight EM LCY bonds, and overweight on EM Asia credit. We highlight our preference for high-quality bonds.

Equities (pages 10-11): As focus shifts from rates volatility to growth volatility, we expect equities to underperform bonds on a risk-adjusted basis in the near-term. However, equities should gain footing in the latter part of the year. It is rather rare for equities to not stage a strong comeback after having lost 20% over the previous year especially if a global recession is avoided as we expect. Earnings risk is something we will watch closely in Q1 as we patiently wait to re-risk. Our high conviction calls are overweight Asia (by geography), and overweight health care, and industrials (by sector).

Alternatives (pages 12-13): With this report, we introduce a new split up of the alternative space that is more representative of the increasing opportunity set. We now see private equity, private debt, real estate, commodities, and hedge funds as key alternative asset classes. After having been neutral alternatives through 2022, we move underweight the asset class. We expect public markets to do well relative to private markets over the next year or so. In the alternatives space, we prefer public REITs, CMBS, and gold. Within hedge funds, we continue to like macro and market defensive strategies.

Currencies (pages 14-15): We expect the USD to weaken from the current levels and do not expect the USD broad rally of 2022 to repeat. However, at the same time, we rule out the possibility of sizeable USD weakness. While we expect euro to stabilise and record a better performance than in 2022, a strong euro rally looks difficult. We expect the pound sterling to remain stable versus the USD and to weaken versus the euro. JPY is likely to strengthen in 2023 amidst tightening of interest rate differentials, and most importantly prospects of broad USD weakness.

Index

Investment strategy (page 2)

Porftolio positioning (page 6)

Fixed income (page 8)

Equities (page 10)

Alternatives (page 12)

Currencies (page 14)

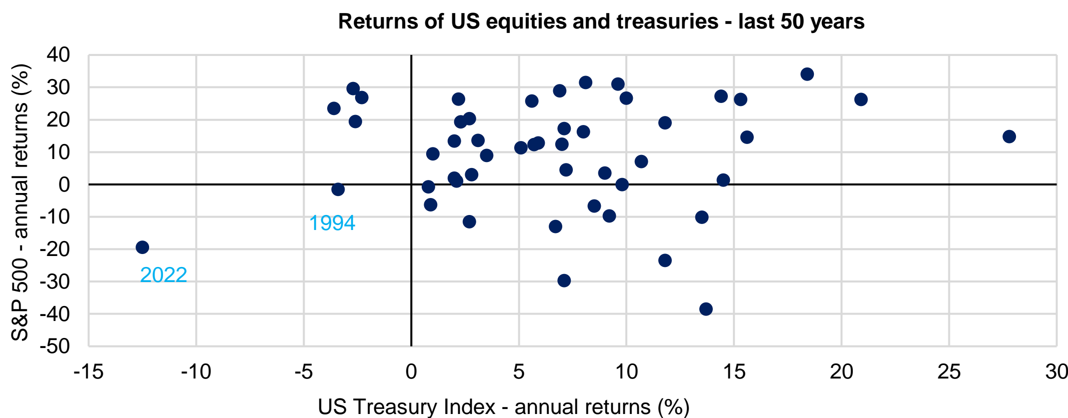
Disclaimer (page 16)

Investment strategy

2022 – a year not to forget
Slowing growth, persistent inflation, rising interest rates, and elevated geopolitical risks have all caused acute volatility in financial markets during 2022. Global growth slowed materially in 2022 after having recovered nicely in 2021 from the pandemic related disruption. Inflation proved less transitory in part due to Russia's invasion of Ukraine and the prolonged conflict that followed. As well lingering virus and China's zero-COVID policy meant persistent supply-side bottlenecks and resultant inflation. As a result, central banks around the world raced to raise interest rates to quell multi-decade high inflation despite slowing growth.

Against this backdrop, global stocks and bonds lost more than USD30trn of their value during 2022. More concerning were the sharply higher correlations across assets with most assets falling and rising simultaneously (exhibit 1). This posed challenges to diversification from an asset allocator's point of view. Rise in risk-free rates meant bouts of sell-off that saw most assets lose value in tandem. As a result, the 60/40 portfolio that invests 60% in equities and 40% in bonds just had its worst year in many decades. For detailed summary of asset class performances during 2022, see our new Multi-Asset Performance Summary – December 2022/Full Year 2022, January 02 2023.

Exhibit 1: 2022 gave investors the very rare experience of losses in both equities and treasuries



Source: S&P, Bloomberg, Refinitiv, and ADCB Asset Management

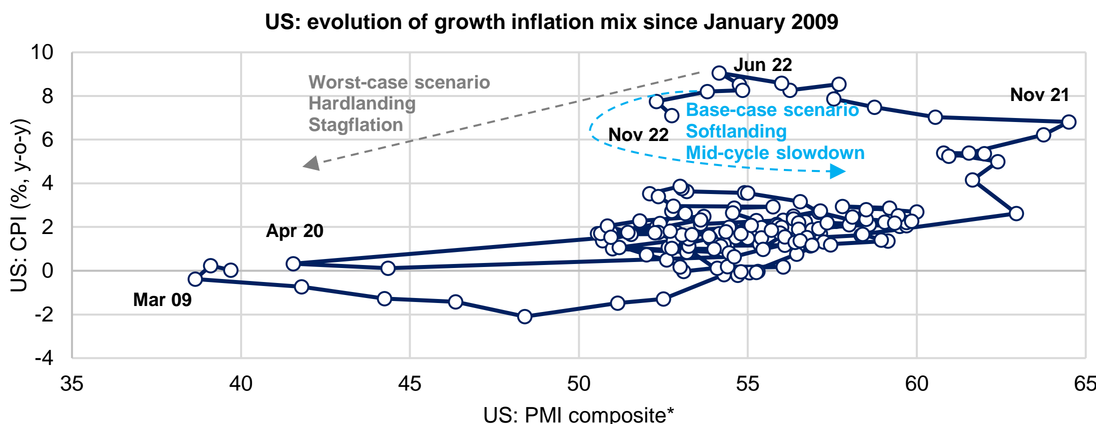
Our counter-consensus macro assumptions that shape our investment convictions
The macro scenario of stagflation defined as below-trend growth and above-trend inflation has become a consensus view amongst market participants. This was evident in the recent Bank of America Global Fund Manager Survey where c90% of the survey participants indicated that they see the global economy experiencing stagflation over the next 12 months. The same survey also pointed to an extremely cautious portfolio positioning with significant overweight in cash and substantial underweight in equities and bonds. (BofA Survey Shows Stagflation Fears With No Fed Pivot in Sight, Bloomberg, November 15 2022). To a significant extent the macro view of stagflation and the cautious positioning are consistent with each other. After all, during 2022 we have seen that the stagflationary environment has not been good for both stocks and bonds, while cash has provided capital protection at least in nominal terms. But we challenge this consensus view for 2023 on two distinct levels. First, we believe that stagflation is unlikely to be the scenario that the global economy faces over the next 12 months (exhibit 2). Second, even if stagflationary environment materializes, there is little value in aligning the positioning with consensus trades.

First on the macro scenario, we have been working with the thesis that the global economy is likely to experience an asynchronous mid-cycle slowdown rather than an outright recession or stagflation. The Eurozone and the UK might continue to experience economic headwinds, but global economic stagflation is at best our low-probability worst-case scenario. Of course, inflation has been a wildcard, but we do expect it to normalize rapidly over the next 12 months. From the headline consumer price index (CPI) and core-CPI excluding food and energy to producer prices and import prices, inflation has come off the boil since last summer. Ranging from falling money supply indicators to easing supply chain pressures to slowing price growth of the services firms, most evidence points to softer inflation ahead.

Against this macro backdrop, the question is whether central banks will be able to pivot towards a more accommodative monetary policy. We are of the opinion that should inflation start to cool off, there is little incentive for the central banks to keep their policy tight for exceedingly long. This would especially be the case if growth slowdown remains significant over the course of 2023. As we have been arguing it is the interplay of growth, inflation, and interest rate policy that would define the trajectory of this cycle and guide the portfolio positioning.

This brings us to the second point of our counter-consensus view on portfolio positioning itself. The consensus reflects its macro concerns also in its allocations. The current consensus positioning of overweight cash and underweight equities and bonds might have worked well in 2022, but this may not be the appropriate strategy for 2023. Also, allocations to private markets might have increased over the past year as mainstream public markets suffered. Therefore, the macro scenario of stagflation and cautious portfolio positioning are a crowded trade already. Conventional wisdom is that there tends to be little value in positioning with the consensus now. Contrarian investors might be able to find better asymmetry in risk-return.

Exhibit 2: Stagflation is not our base-case



Source: Institute of Supply Management (ISM), Bureau of Labor Statistics - US, Refinitiv, and ADCB Asset Management | Notes:*simple average of manufacturing and services ISM PMIs

In summary, here are our macro convictions

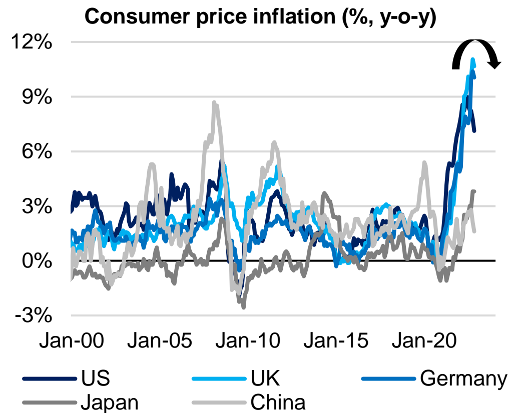
- Global economy to experience an asynchronous mid-cycle slowdown, not a recession.
- Inflation to fall faster than expected thereby giving central banks some room to manoeuvre.
- Bringing down inflation does not need a recession.
- Central banks will have little incentive to keep rates at higher level if inflation cools rapidly, especially when the growth slows to below-trend.
- Uncertainty around “long and variable lags” is likely to shift the risk-balance for central banks.

Three peaks and three valleys that define 2023 landscape

Our 2022 outlook was largely centered around the evolution of the growth inflation mix (for details see 2022 Outlook: Catch’22, January 2022). Whilst this macro phenomenon continues to be key driver of the financial market cycle, we think there are more factors for investors to consider this year. Investors trying to navigate this year’s landscape are likely to encounter three peaks and three valleys (troughs). Peaks in inflation, interest rates, and the USD along with the troughs in global growth, corporate earnings growth, and investor sentiment are all likely to be the key market-driving events during 2023.

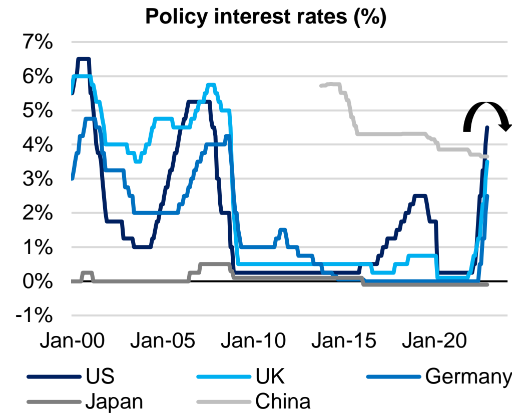
We believe that inflation is in the process of slowing rather sustainably across major economies (exhibit 3), and this should in turn allow interest rates to hit a peak level after having risen substantially over the past several months (exhibit 4). The USD which has benefitted from weakening global growth and hawkish Fed, should weaken as a global recession is avoided and the Fed reaches its peak hawkishness (at least in relation to other major DM central banks). Perhaps the recent USD weakness was already reflective of this (exhibit 5). Global growth has weakened through 2022. High frequency economic indicators – like for instance purchasing managers’ indices (PMIs) have fallen below 50 – broadly are indicating contraction (exhibit 6). However, should our macro scenario of the mid-cycle slowdown materialise, real economic indicators should start to pick-up at some point. This should also support the corporate sector where earnings are likely to reaccelerate after hitting a cyclical trough (exhibit 7). Finally, the investor sentiment – which has been bearish – should begin to improve (exhibit 8). Probabilities of these six inflections are likely to influence market performances during 2023. Ambiguity around achieving these is a primary source of uncertainty.

Exhibit 3: Inflation appears to have peaked across major developed markets



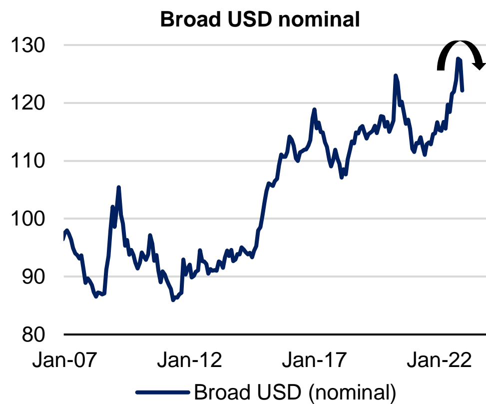
Source: Statistical Offices, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 4: Policy interest rates should hit their cyclical peaks soon



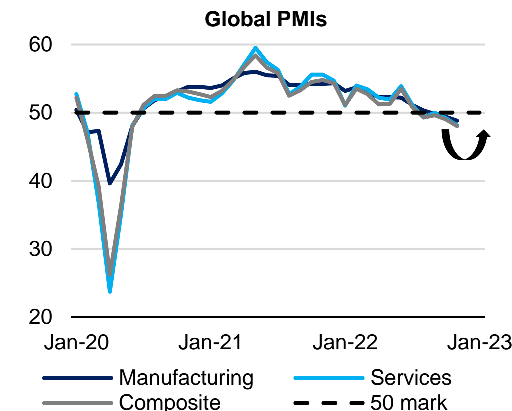
Source: Central Banks, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 5: Acute USD strength may be the story of the past



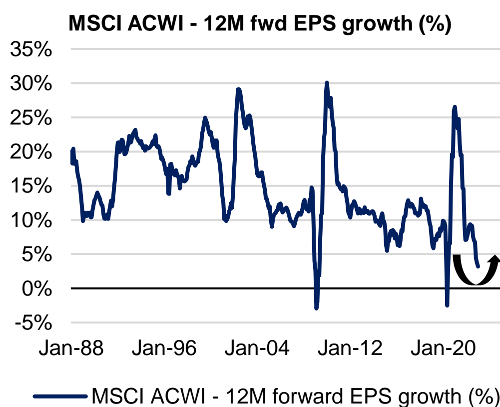
Source: Datastream, Refinitiv, and ADCB Asset Management

Exhibit 6: Global growth to hit a trough later this year



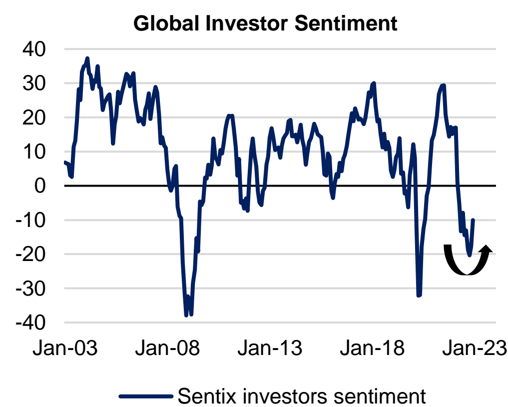
Source: S&P Global, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 7: Earnings growth projections should follow economic expectations



Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 8: Investor sentiment globally might have just passed its local minimum



Source: Sentix, Datastream, Refinitiv, and ADCB Asset Management

Risks to our outlook

Our constructive view is not without risks. A broad range of risk considerations are likely to influence market volatility over the next year. Below is our grouped list of risks.

- Economic
  - A deep recession in the US
  - Sticky inflation across major DMs
  - Even tighter monetary policy across DMs
  - New COVID-19 variant creates economic disruption
  - Expedited decoupling of China-US
  - A pick-up in economic activity rather than a mid-cycle slowdown (upside risk)
- Environmental
  - Extreme weather events create food crisis
- Political
  - Debt ceiling in the US
  - Elections (Finland, and Turkey)
  - Worsening EU energy crisis
  - Sticky inflation and higher food prices prompt civil unrest in developing markets
- Geopolitical
  - Further escalation of the Russia-Ukraine conflict
  - China-Taiwan
  - US-Iran tensions lead to higher oil prices
  - Cyberwars

How should investors position?

We think 2023 is likely to be the year of active management with timing of the peak and valleys (discussed above) being very important. For instance, in the immediate near-term, markets are likely to look more closely at growth (rather than inflation) in determining the probability of a peak interest rates. Accordingly, investors' focus should shift from inflation volatility premium to growth volatility premium. To that extent, we expect bonds to outperform equities in the near-term. We also think bonds can outperform all other asset classes over the next 12 months on risk-adjusted-returns basis. Beyond the near-term, once the market participants gather enough evidence of the trajectory on growth, inflation, and interest rates, risk assets are likely to outperform. Reflecting all this, the asset allocation needs to evolve over the course of 2023. We start the year with making changes to our asset allocations and foresee further changes in the coming months.

Changes to our positioning/views

- At the asset allocation level, we upgrade fixed income to an overweight from underweight, and downgrade alternatives to an underweight from neutral. We maintain our overweight in cash and neutral position in equities.
- Within equities, our regional and factor preferences remain unchanged. By sectors, we upgrade financials to neutral from underweight and fund this by downgrading communication services to a neutral from overweight.
- Our allocation and preferences within the fixed income space remain unchanged. However, with this note we redefine the key groups within the asset class (see portfolio positioning on pages 6-7).
- In the alternatives space, we reorganise the sub-asset class segments to include private equity (underweight), private debt (neutral), real estate (overweight), commodities (neutral), and hedge funds (neutral).
- On currencies, we are now negative on USD (positive before), positive on JPY (were negative), neutral on EUR and GBP (were negative on both). We maintain our neutral stance on EM currencies.

High conviction macro investment themes

- Prefer services to manufacturing
- Prefer domestic consumption to exporters
- Prefer public markets to private markets
- Expect lower volatility in fixed income compared to equities (at least in the initial months of the year)

For our recommended portfolio positioning and associated investment ideas, see exhibit 9 on pages 6-7.

Porftolio positioning

Exhibit 9: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities		No change		Diversified exposure to quality and non-cyclicality
Fixed income	Old		New	Improved risk-return profile with ample yield
Alternatives	New	Old		Prefer public REITs, CMBS, and gold
Cash and liquidity			No change	Waiting to re-risk
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US			No change	Prefer equal weighted indices; focus on quality
Canada		No change		Stick with the benchmark
Europe ex UK	No change			Focus on quality and China-exposure
UK			No change	Prefer global large caps with quality-tilt
Japan			No change	Improving governance, and cheap valuations
Asia Pacific ex Japan			No change	Prefer China and ASEAN
EM LatAm	No change			Constrained by commodity-dependence, debt vulnerabilities, outflows, and weak currencies
EM EMEA	No change			(EM LatAm and EM EMEA share the comment above)
GCC		No change		Stick with the benchmark
Global sectors				
Comm. Services		New	Old	Prefer defensive sub-sectors
Consumer Discr.		No change		Hotels, Rest. & Leisure, and Consumer services
Consumer Staples		No change		Food, Beverage & Tobacco
Energy		No change		Capital discipline and makeover plays
Financials	Old	New		Focus on growth opportunities in Asia; yield plays
Health Care			No change	Prefer defensively-oriented inexpensive segments
Industrials			No change	Industrial automation and IoT; likely GICS change
IT		No change		Cautious on tech hardware and semiconductors
Materials	No change			Prefer gold miner equities
Real Estate		No change		Real estate management & development sector
Utilities	No change			Gas utilities and Renewable Electricity Prod.
Factors/styles/sizes				
Large cap			No change	Strong balance sheet, earnings visibility
Mid cap		No change		Likely to be market-performers
Small cap	No change			Strained by leverage and peak-growth
Growth			No change	Strong preference for non-cyclical growth
Value		No change		Avoid value in sectors facing disruption
Dividend yield			No change	Prefer quality dividends and dividend growth
Quality			No change	Quality in the environment of low risk-tolerance
Momentum		No change		Market leadership changes to impact negatively

Legend *New* (grey box) *Old* (white box) *No change* (grey box with border)

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks.

Exhibit 9: Recommended portfolio positioning (continued)

Fixed income**	Underweight	Neutral	Overweight	Comments
DM Sovereign IG				Overweight on 7-10yr USTs
DM Corporate IG				Short-intermediate bonds, High-quality preference
EM HCY Sovereign				Selective on HQ*** GCC, Oman and Brazil
EM LCY Sovereign				EM policy normalization
EM HCY Corporate				Preference for Asia IG with spreads attractive
Global HY****				Short-dated, high-quality preference

Alternatives	Underweight	Neutral	Overweight	Comments
Private equity				We see relative attraction in public equity
Private debt				We see relative attraction in public debt
Real estate				Prefer public REITs and CMBS
Commodities				Prefer gold as hedge against geopolitical risks
Hedge funds				Macro and market defensive strategies

Currencies	Negative	Neutral	Positive	Comments
USD				Dollar rally to end with the end of Fed's tightening
EUR				Euro pricing in the risks
JPY				Interest rate differentials to tighten
GBP				BoE to be less hawkish than expected
EM currencies				Driven by idiosyncratic developments

Legend *New* *Old* *No change*

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: **Positions recommended based on Bloomberg Global Aggregate (USD unhedged) Index benchmarks; Other components including securitised debt, agencies and supranational are not covered here. ***HQ = High Quality. ****Global HY is off benchmark position.

Fixed income

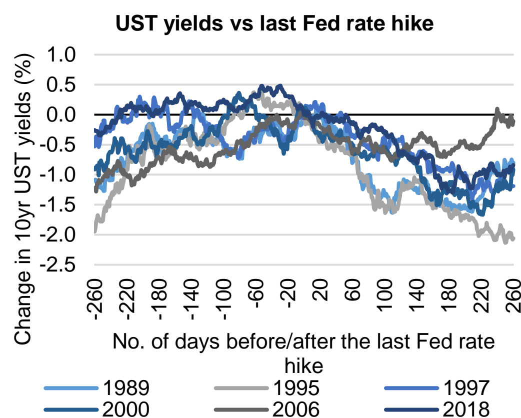
Silver linings playbook

2022 has been the most challenging year for the global bond markets. Bloomberg Global Aggregate Bond Index declined by 16% in 2022, posting the worst annual performance in the history of the index. Negative returns were evident across the board in fixed income space on the back of co-ordinated global central bank tightening response to the rise in global inflation pressures. Global sovereigns and investment grade credit both lost c17% each, and global high-yield credit declined by 13%. Global inflation linked bonds fell 23% despite the elevated inflation as interest rates increased. US Treasuries posted annual losses of 13% in 2022.

After the dismal performance in 2022, we believe the worst may be behind for fixed income assets. We upgrade fixed income to overweight (from underweight) on prospects for better risk-adjusted returns. Of course timing the peak of the interest rate cycle is difficult but we believe that it will likely happen at some point this year – allowing fixed income assets to perform well over the medium-term. Moreover, once inflation cools down (as we expect), correlation between equities and bonds could once again turn negative. With starting point of higher yields and negative correlation with equities, fixed income could once again become a credible alternative to equities.

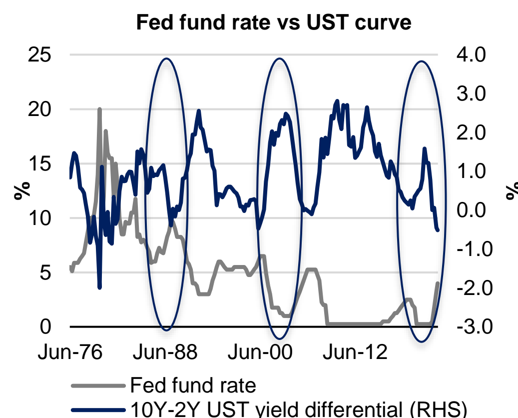
2023 is likely to be the year of duration, in our view. Firstly, the 10yr UST yields tend to peak much ahead of the Fed's terminal rate of the hiking cycle. This has been evident at the past six Fed tightening cycles (exhibit 10). In addition, the 10yr UST yields have also never crossed the peak Fed fund rate in the past tightening cycles. Secondly, while 2022 was the worst year for the bond volatility amidst inflation and Fed policy uncertainty, we believe that the bond volatility is likely to have peaked and will stabilise with prospects of more clarity on Fed policy and reduced inflation uncertainty in 2023. Unlike 2022, we are likely to witness a more predictable interest rate policy. Lastly, 2023 will not only be the year of duration but also the year of UST yield curve steepening where rates will decline across the UST curve, but led by the short-end rates. The 10Y-2Y UST yield curve begins to steepen with the Fed pauses and the steepening picks up momentum once the Fed starts to cut rates (exhibit 11). As a result, we maintain our overweight stance on US Treasuries with a preference for the 7Y-10Y segment.

Exhibit 10: UST yields peak before the last Fed rate hike



Source: Bloomberg, and ADCB Asset Management

Exhibit 11: UST steepening begins with the Fed pause



Source: Bloomberg, and ADCB Asset Management

Neutral on US and EU IG, Underweight on US and EU HY, Preference for high-quality bonds

DM corporate bonds suffered losses in 2022 on the back of increased bond market volatility and aggressive central bank response. DM corporate IG bonds were the worst performers on account of their long-duration characteristics. Bloomberg US IG bond index recorded losses of 16% while US HY lost 11%. Bloomberg European IG Index declined by 13% in 2022 while European HY dropped by 11%. After the significant underperformance in 2022, US IG valuations have become attractive not only versus fixed income peers but also versus equities. The US IG yield and S&P 500 dividend yield differential is at the widest level since the global financial crisis. We remain neutral on US IG but wait for opportunities to add exposure once the recession risks subside. In terms of sector, we prefer long-duration sectors including utilities and transportation for 2023 but in the short-term, banking- short-duration sector- looks attractive in terms of valuation. In US HY, we still remain cautious. We believe the worst may not yet be over for US HY given its sensitivity to equity market volatility, tightening of US financial conditions and likelihood of sharp jump in

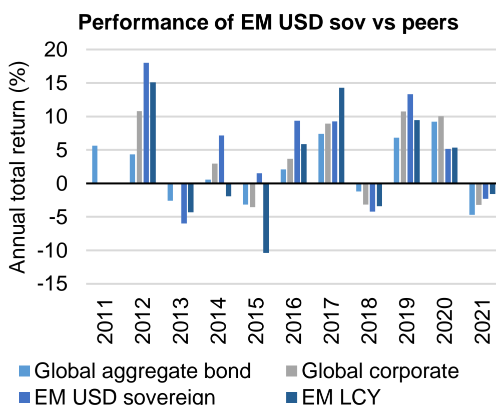
default rates in the event of an economic downturn. We maintain our underweight stance on US HY. In terms of rating-wise preference, we stick to higher quality segments in both US IG and US HY.

Separately, we hold a more positive outlook on European corporate bonds relative to US corporate bonds. European IG spreads have widened more than US IG spreads, highlighting the rise in recession concerns and tightening of financial conditions in Europe. At current wide levels, European IG spreads are fully accounting for the recession risks.

Stay Neutral on EM USD sovereigns, Underweight on EM LCY bonds; Overweight on EM Asia credit
2022 was a challenging year for EM USD bonds. Combination of external factors- USD strength, rising UST rates and volatility, tightening US financial conditions, as well as idiosyncratic domestic issues and China growth slowdown were responsible for the EM bond performance. Whether the worst is now behind us largely depends on the prospects of waning USD strength and evidence of sustainable pick-up in China growth momentum. USD strength has been detrimental for EM USD sovereigns, given majority of the EMs rely on dollar funding to repay their debt. EMs have faced significant drawdown in currency reserves to support their domestic currencies, providing less buffer against further rise in USD. Easing USD strength could provide some relief for the EM USD sovereigns. EM USD sovereigns are also likely to benefit from the eventual China re-opening and rise in China credit flow. Looking at the bright side, after the excessive sell-off, EM USD bond valuations are looking attractive versus peers. In addition, average EM 5yr CDS spread is quite wide compared to the EM economic activity surprises-implying that most of the negative news is already priced in. Finally, according to the IMF, EM-DM growth differential is forecasted to widen in 2023, on account of stable EM growth versus growth contraction expected in DM. Last time when the growth differential was this wide was in 2016 when EM USD sovereign bonds had recorded strong annual gains of c9.3% (exhibit 12). Having said that, EM bonds are likely to face a rocky path to recovery. Besides the idiosyncratic domestic issues, external headwinds remain for EM USD bonds particularly in terms of their vulnerability to the US financial conditions (exhibit 13) and strong correlation with the MOVE Index (UST volatility). As such, we maintain our neutral stance on EM USD sovereign bonds. We also emphasize on remaining selective within the asset class, sticking with countries backed by strong fundamentals- this includes high quality GCC sovereigns and Oman.

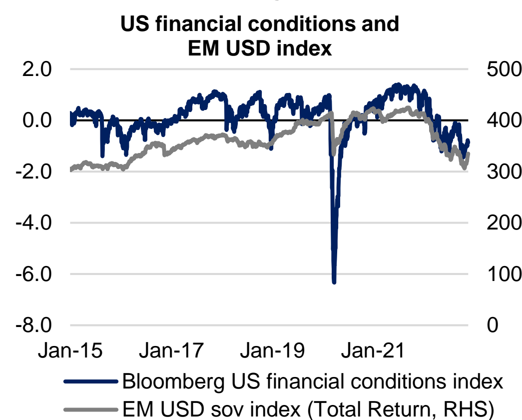
In EM corporate, we retain our preference for Asia credit through our overweight stance on Asia IG bonds. Asia IG bonds outperformed US IG and EUR IG bonds in 2022, despite declining by 10%. As a result, valuations have become expensive compared to US IG and EUR IG. Positive turnaround in China's credit impulse is likely to prove supportive for the sector. Asia HY - though trading at attractive levels – could continue to face volatility amidst the struggling real estate market.

Exhibit 12: EM USD sov. outperform during EM growth outperformance



Source: Bloomberg, and ADCB Asset Management

Exhibit 13: Tightening of US financial conditions – a risk for EM USD sovereign



Source: Bloomberg, and ADCB Asset Management

Equities

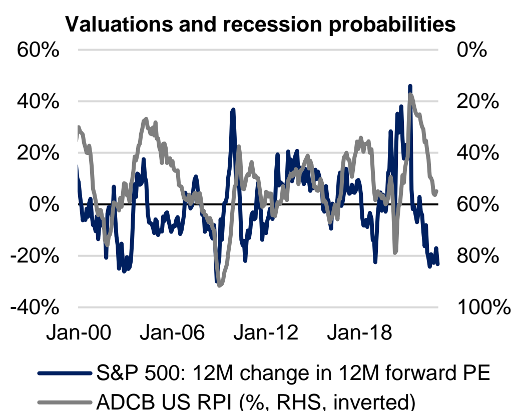
As discussed in the investment strategy section of this report (pages 2-5), deteriorating growth-inflation mix caused equity markets to drop by c20% during 2022, the biggest decline since 2008. Developed market equities lost 19% while emerging market equity losses touched 22%. Within developed equity markets, UK, Canada, and Japan outperformed in USD terms. In the emerging markets space, Latin American and GCC markets held up relatively well. Despite posting marginal losses, GCC equities managed to outperform global equities during 2022. Higher oil prices, disciplined fiscal outlays, controlled inflation and strong growth have all helped. Within the region, Abu Dhabi and Oman stocks posted strong positive returns while Saudi and Qatar equities registered losses. Amongst sectors, energy equities not only outperformed but also posted significant positive gains over the year. Elsewhere, defensive sectors including utilities, health care, and consumer staples outperformed, albeit posted losses. Long-duration sectors including communication services, consumer discretionary, and IT were severely negatively impacted by rising interest rates.

Following a bear market year, the outlook for 2023 can look rather challenging. However, looking back at the history, we notice that over the past 75 years, S&P 500 index has experienced nine drawdowns in excess of 10%. In seven of these nine instances, the index rose by an average 18% in the following year. The two exceptions followed the extreme events of the oil price shock (1973) and dotcom bubble (2001). Even for other equity indices two consecutive years of losses have been rare. So to that extent, history remains supportive of a positive return year for equities. But the question is if this time is different? For this we look at the two drivers of equity returns – valuations and earnings.

Valuations

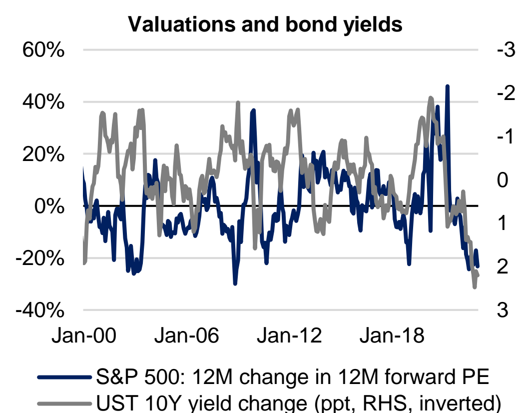
Looking at valuations, most of the drawdown of 2022 came from the contraction in valuation multiples. Therefore, the question now is whether equity valuations have already discounted the information provided by the key macro trends. In our view, equity valuations are currently being driven by rising recession probabilities and expanding bond yields. Recession probabilities have certainly risen last year but from a low base. Our proprietary recession probability indicator for the US has risen sharply from a very depressed level of below 20% at the start of 2022 to the current level of 55% (exhibit 14). Historically, rises in recession probabilities compressed equity valuations. We saw this also happen during 2022. However, we would note that the compression in equity valuations was rather excessive compared to the rise in recession probabilities and the magnitude of compression during 2022 was comparable to that during global financial crisis of 2008/09. Of course, the starting point of valuations was rather high this time around; nevertheless, we see a mean-reverting behaviour in the valuations changes metric. Two points to take away from here. First, most of the recession considerations might be in price already – at least in terms of valuations. Second, should our base-case of 'a mid-cycle slowdown and not a recession' materialise, valuations may even move higher.

Exhibit 14: Equity market valuations seem to have adjusted to rising recession probabilities…



Source: S&P, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 15: …and sharp rise in bond yields



Source: S&P, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

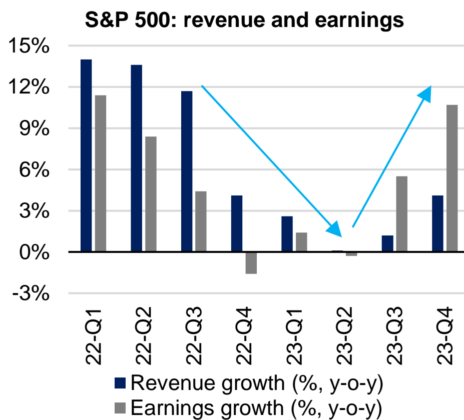
The second driver of valuations is bond yields. Historically, as bond yields increased, equity valuations rose too, reflecting the choice between equities and bonds. However, given the hawkish narrative from the central banks last year, equity valuations compressed while bond yields rose (exhibit 15). Comparing the moves in both equity valuations and bond yields over the past 12 months, equity valuations seem to be reflecting the sharp rise in rates already. Further, any stabilisation in rates should now mean support for equity valuations.

Earnings

In 2022 we saw upside to earnings estimates which did materialise (see 2022 Outlook: Catch'22, January 2022). However, earnings picture might be a lot more challenging this year. For instance, I/B/E/S consensus expects MSCI ACWI earnings to grow 3% in 2023. Whilst this may not be much, we see limited downside risks. In case our worst-case scenario of a recession does materialise, earnings will have scope to fall further. Yet, in absence of a recession, earnings may prove to be resilient in relation to consensus expectations. However, we would not emphasise much on upside for earnings.

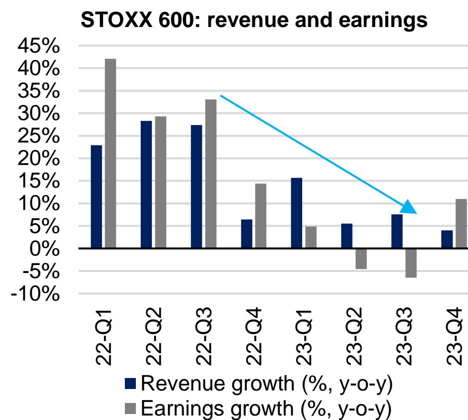
While Q4 2022 corporate earnings season is likely to provide more evidence on the trajectory of future earnings, it is also likely to be the key source of volatility when it gets underway in Q1 2023. Therefore, we do expect volatility in equities to be higher than that in bonds over this time frame. This is in part the reason why we prefer bonds over equities in the near-term. However, Q2 2023 is likely to be the trough in corporate earnings – at least in the US (exhibit 16). Markets being forward looking may start to discount this better H2 2023 in Q2 2023 itself. Therefore, beyond the near-term we would turn more constructive on equity risk. In case of Europe, earnings recovery is likely to come only towards end of this year (exhibit 17) making a relatively more cautious case for European equities in the global context.

Exhibit 16: US earnings to rebound in H2



Source: S&P, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

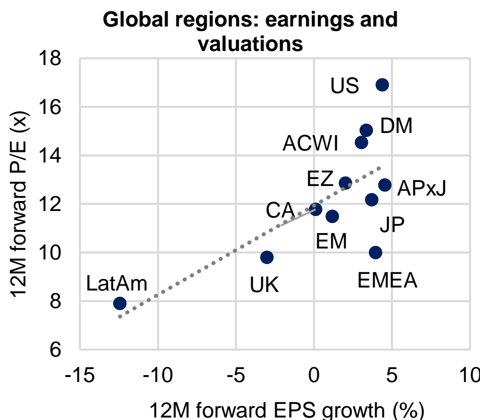
Exhibit 17: European earnings rebound later



Source: STOXX, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

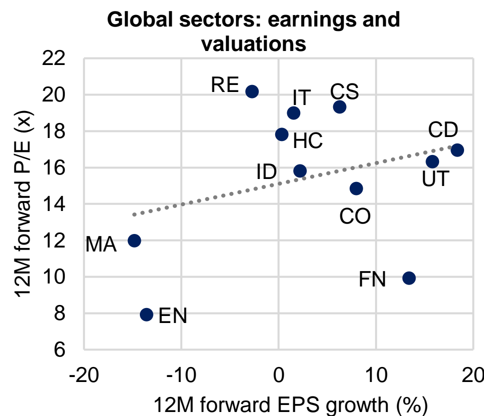
Comparing valuations and earnings, we see the relative attraction of Asian markets – where for the expected earnings growth valuation are not expensive (exhibit 18). US equity valuations remain expensive but for valid reason of being high-quality. Sector wise, financials looks relatively cheap (we upgrade the sector to neutral from underweight). Our key overweights – health care and industrials – look reasonably valued and we would use these positions as the barbell strategy for recession risk (exhibit 19). Communication services sector looks marginally attractive too but we turn cautious ahead of Q4 2022 earnings season (we downgrade the sector to neutral from overweight).

Exhibit 18: Asian and UK markets offer value



Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 19: Tech sectors still don't look cheap



Source: MSCI, I/B/E/S, Datastream, Refinitiv, and ADCB Asset Management

Alternatives

With this report, we introduce a new carve out of the alternative space that is more representative of the increasing opportunity set. We now see private equity, private debt, real estate, commodities, and hedge funds as key alternative asset classes.

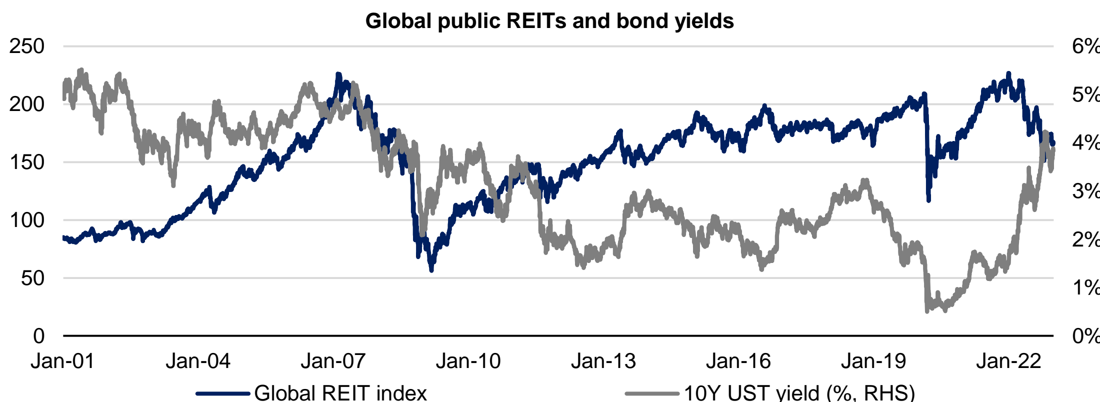
After having been neutral alternatives through 2022, we move underweight the asset class. We deploy these funds to raise fixed income to an overweight. There are two macro considerations behind this move. First, we expect public markets to do well relative to private markets over the next year as the former have already adjusted lower over the past year and the adjustment for the latter comes with a lag of 12 to 18 months on an average. Second, within the mainstream public markets, we see value in bonds over equities over the three-month time frame (for discussion see investment strategy section on pages 2-5 and equity market section on pages 10-11). However, within the alternatives space, we prefer public REITs, CMBS, and gold. Within hedge funds, we continue to like macro and market defensive strategies which have worked well during 2022.

Real Estate
Real estate has gone through a difficult year in 2022 as interest rates rose sharply at a time when growth was slowing (exhibit 20). Of course this came after some segments of the sector experienced a strong post-pandemic rebound in the prior years. Whilst 2023 looks challenging for the sector, we think there could be opportunities after last year's correction. Even here we prefer publicly-listed and liquid segments of the real estate sector – hence our preference for public REITs and CMBS.

Whilst the commercial real estate activity is likely to be slow in the year ahead following a slow H2 2022, we think opportunities could start to emerge at some point this year. Investors with a higher risk tolerance could opportunistically focus on investing in liquid public market instruments like CMBS and Real Estate Investment Trusts (REITs). Public market quadrants not only reflect a repricing in real estate values, making them relatively attractive (as of December 2022), but also allow investors to rapidly implement a risk-on tilt in their portfolios. While timing the trough in public quadrants is nearly impossible, they allow investors to nimbly access periods of market dislocation as well as be positioned for recovery when central bank policies shift, which is likely at some point.

Thinking more thematically, we believe it is important for investors to anchor their portfolios around disruptive and structurally strong property types and markets, with their resilient tenant drivers and cash flows. Here, one should think about long-term trends – such as demographics, innovation, globalization, technology, and urbanisation – that are reshaping the real estate landscape. These should be a core underpinning of real estate portfolios and strategies. Portfolio with such disruptive/structural markets and property types is potentially expected to outperform given the resiliency of their tenants, location, and cashflows. All investment strategies should try to overweight these long-term drivers. Worth noting that public markets, more than private markets, have embraced these emerging sectors. For instance, 57% of the US NAREIT Index is constituted by the niche sectors of infrastructure, healthcare, data centres etc. While the private side has started to embrace these new segments, the representation on the index remains fairly low – share of niche property types in NCREIF National Property Index is still low at just c7%.

Exhibit 20: Listed real estate markets felt the pain of rising rates



Source: S&P, Bloomberg, and ADCB Asset Management

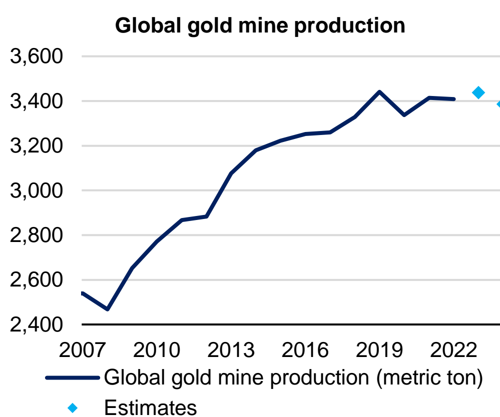
Commodities
Commodities in aggregate have been the best performing asset class over the past two years. The asset class group had a relatively strong year with aggregate commodity index rising 14% during 2022. However, looking inside this performance, two points can be made. First, most of the commodity price strength came in the first half of the year. Second, looking at sub-groups, prices of energy and agricultural commodities rose while prices of industrial and precious metals fell. Gold prices remained largely unchanged through 2022. Silver prices rose marginally, while platinum prices increased. Energy prices rose strongly in 2022 thanks to disruptions caused by the Russia's invasion of Ukraine, disciplined OPEC+, and some weather related disruptions. Industrial metals prices fell sharply during 2022 on weak demand outlook.

Looking ahead, it is very hard to make a case for commodity prices to rise further. Especially, should inflation start to come in softer than expected, and should the growth start to weaken, commodities could become vulnerable. In fact, we may have already seen this play out during H2 last year. Granted, the peak USD, China reopening, decarbonisation, and underinvestment are all supportive. But we think they at best put a floor under the current elevated commodity prices. We are not believers of another commodity super-cycle, but we think demand for green-commodities could sustain in the long run. Fortune of food commodities is closely tied to the weather patterns which are becoming more unpredictable. In fact, in the investment strategy section of this report, we highlight weather related disruption to food production as a key risk.

We are neutral commodities within alternatives. Within the commodity space, we prefer gold as a hedge against geopolitical risks. Demand from Asia should pick up into 2023. But central bank buying remains the key source of demand for this precious metal when the supply/production is flat-lining (exhibit 21). However, the Fed's hawkish stance is likely to weigh in the near-term. But as this major headwind abates, price rises could be sharper in the latter part of 2023. Weakening USD is a major tailwind too.

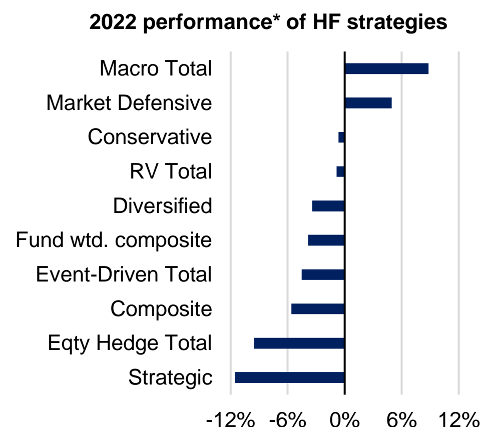
On oil, we think prices are likely to be range-bound this year in absence of a major supply-side or even demand-side shocks. Russia's oil production could fall in response to the recent oil price cap there by eliminating any price implications. China's demand recovery could come at a time when global growth slows. US refilling of its strategic petroleum reserves is likely to be only gradual. OPEC+ is likely to act in case the demand outlook weakens substantially. Weakening USD is usually a tailwind but 2022 experience of both USD and oil prices rising simultaneously suggests this time could be different.

Exhibit 21: Gold production is flat lining



Source: Datastream, Refinitiv, and ADCB Asset Management

Exhibit 22: Macro strategies outperformed in 2022



Source: HFRX, Bloomberg, Refinitiv, and ADCB Asset Management | Notes: *based on data as at close of November 30, 2022.

Hedge funds
We are neutral hedge funds in the alternatives context with a retained preference for macro and market defensive strategies that have worked very well last year (exhibit 22). Macro could still provide a fertile ground for hedge fund investors especially as the global growth slowdown takes hold and central bank policies diverge. We would use our preference for market defensive strategies as a hedge against any downside risks to our positions in fixed income (overweight) and equities (neutral).

Private debt and Private equity
Our neutral stance on private debt and underweight on private equity reflects two of our broader preferences: public markets to private markets, and bonds to equities (in the near-term).

Currencies

US Dollar

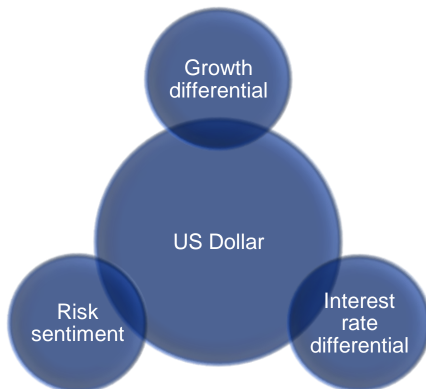
While 2022 proved to be tumultuous year for various asset classes, it was one of the best years in decades for the USD. The dollar index rose 8% in 2022, receiving boost from the Fed's pivot to hawkish monetary policy. Rise in interest rate differential between the US and the rest of the world as the Fed led the race of tightening was the biggest supporting force for the USD. However, we believe that this supporting force is likely to wane in 2023. US interest rates remain wide compared to DM peers, but this widening is likely to slow as and when we see the Fed hitting the brakes on interest rate hikes. Other central banks are still lagging behind in the tightening race, catching up with the Fed and may not necessarily promptly follow the Fed path of pause/cutting interest rates. Another reason why we believe that interest rate differentials could not be as influential in 2023 is the possibility of less Fed policy uncertainty and lower interest rate volatility. In fact, decline in interest rate volatility has been an important factor in driving the USD weakness in Q4 2022 (exhibit 24).

With interest rate differentials and interest rate volatility likely to take a backseat, upward pressure on the USD is likely to come-off. On the other hand, growth differential and risk sentiment will take centre-stage in determining the path of the USD in 2023 (exhibit 23). When it comes to growth differential, a synchronised global slowdown could lead to significant weakness in the dollar. However, this is neither our expectation nor currently priced in by the market. Market consensus expectations indicate that US growth is likely to slow down in 2023, but the deceleration in economic activity is not expected to be as bad as in the case of UK and Eurozone (exhibit 25). US growth outperformance could limit the USD weakness. On the other hand, US growth disappointment (negative surprise) could prove to be hurtful for the USD. Risk sentiment is another factor that could restrict the extent to which the USD could depreciate. USD remains the most preferred safe-haven asset during periods of increased volatility and risk-off sentiment. Overall, we expect the USD to weaken from the current levels and do not expect the 2022 broad USD rally to repeat. However, at the same time, we rule out the possibility of sizeable USD weakness.

Euro

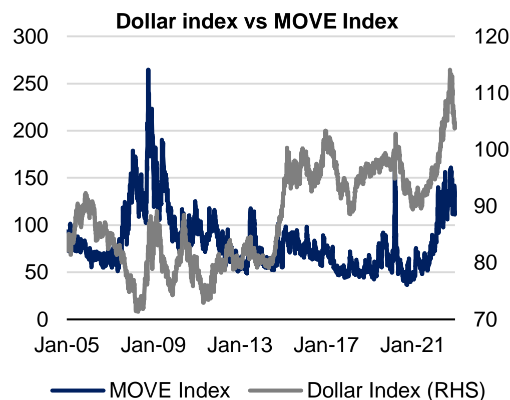
With the dollar bull being the main theme, 2022 proved to be a disappointing year for the euro. Rise in geopolitical risks amidst the close proximity to Russia-Ukraine war, elevated inflation pressures and ECB lagging the tightening cycle were the negative factors influencing the performance of the euro. While it is difficult to predict if these factors will completely fade away in 2023, the currency is already fully pricing in these risks. On the positive side, China re-opening optimism is a supportive factor for the euro in 2023. Euro stands to benefit from a prospective cyclical rebound in China's economy. Having said that, while we expect euro weakness to stabilise and expect the currency to deliver a better performance in 2023 than 2022, a strong euro rally looks difficult. This is on account of the challenging economic situation in the region. The probability of a recession over the next 12 months are the highest in the UK and Europe (exhibit 26).

Exhibit 23: Rate differentials to take backseat



Source: ADCB Asset Management

Exhibit 24: Interest rate volatility to decline

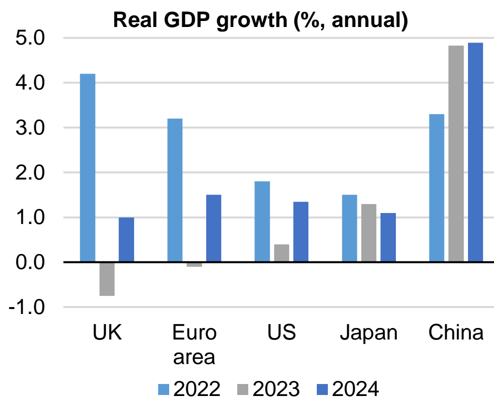


Source: Bloomberg, ADCB Asset Management

Pound sterling

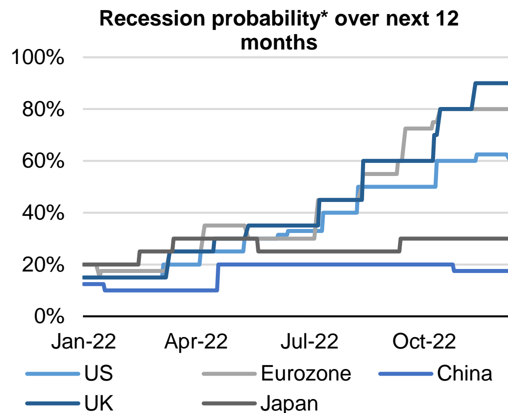
The pound sterling weakened versus the USD but remained relatively stable vs the euro in 2022 (exhibit 27). The pound sterling had a volatile ride in 2022 on the back of BoE hawkish pivot, political uncertainty combined with fiscal policy uncertainty, persistent inflation and deteriorating economic outlook. Political situation has improved after the appointment of UK PM Rishi Sunak and fiscal clarity has been restored. However, the country still faces problem of twin deficits. In addition, weakening economic outlook mean that the BoE could be more dovish than expected as the probability of an economic contraction over the next 12 months are the highest in the UK. Given the BoE has closely matched the Fed tightening cycle, we expect the pound sterling to remain stable versus the USD. However, we expect the pound sterling to weaken versus the euro.

Exhibit 25: UK and Eurozone likely to face growth contraction in 2023



Source: Bloomberg consensus (November 2022), and ADCB Asset Management

Exhibit 26: UK and Eurozone has the highest 1yr probability of recession

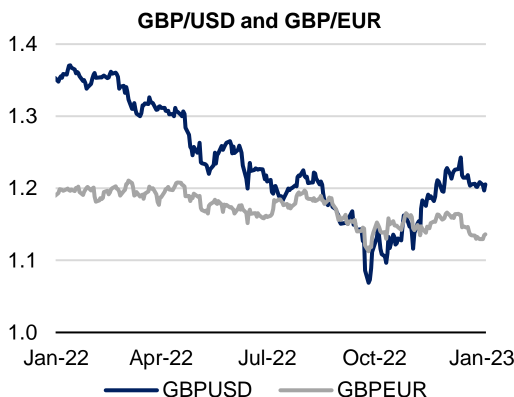


Source: Bloomberg, and ADCB Asset Management | Note: *The recession probabilities are not ADCBs RPIs

Japanese Yen

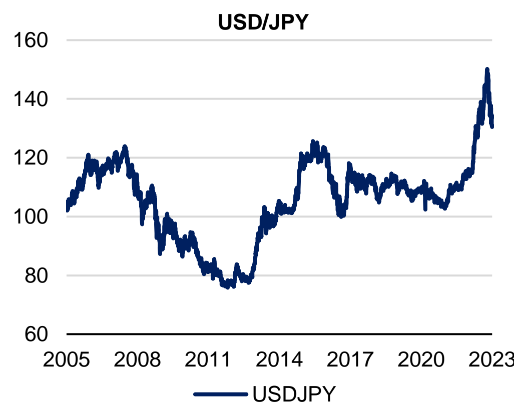
JPY weakened significantly against the USD in 2022 with rise in UST yields, broad USD strength and further widening of interest rate differential between US and Japan putting downward pressure on the yen (exhibit 28). Extreme JPY weakness even compelled the BoJ to intervene in the FX market for the first time since 1998. We expect JPY to strengthen in 2023 amidst the peak in UST yields leading to tightening of interest rate differentials, possibility of less hawkish Fed and most importantly prospects of broad dollar weakness. Interest rate differentials between US and Japan are likely to tighten not only due to prospective decline in UST yield but also simultaneous rise in JGB yields after the BoJ surprise tweak in the yield curve control policy. In fact, the possibility of BoJ exiting from ultra-loose monetary easing have risen after the December tweak in yield curve control policy and recent reports of the central bank considering to upgrade inflation forecasts.

Exhibit 27: Pound sterling weakened versus USD



Source :Bloomberg, and ADCB Asset Management

Exhibit 28: Yen weakened versus USD



Source: Bloomberg, and ADCB Asset Management

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