The Investor
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2023 Investment Outlook – Ireland & the World

Following a difficult year for most asset prices, growth is expected to recover in the second half of 2023. As markets tend to lead the economy, this should provide a more benign environment for investors.

The backdrop for the global economy and investment markets has changed significantly compared to expectations at the beginning of 2022, with inflation proving to be persistent and the global economy rapidly transitioning from mid to late cycle.

Inflation has risen to the highest levels in over 40 years. This has resulted in a major policy shift among global central banks with the most aggressive tightening of monetary policy in several decades, through a combination of rising interest rates and balance sheet reduction. With inflation rising well above wages, real incomes have been squeezed and consumer purchasing power has been severely reduced. This has resulted in global growth forecasts for 2023 of only 1.8%. However, inflation appears to be peaking and has already begun to fall in some regions.

The various shocks which have hit the global economy have caused growth to slow, with increasing fears of a global recession. The squeeze in real incomes has caused consumer confidence to fall significantly. Business sentiment surveys have also fallen sharply as demand has weakened. Combined with the surge in gas and energy prices due to the conflict in Ukraine, Europe and the UK have suffered more than most and consensus forecasts now see both as already being in recession. Even with growth expected to slow further in the early part of 2023 and the growing risk of a US recession, any slowdown or recession could be relatively short and shallow.

The excesses prior to previous recessions in terms of the build-up of surplus capacity or stretched consumer and corporate balance sheets are not evident to the same extent on this occasion. As a result, the depth and length of the slowdown could be more modest. Fiscal support measures are likely to be implemented to combat any further deterioration in the growth outlook, which would also ease risks around the severity and length of the slowdown.

Upside to growth could come from a resolution to the war in Ukraine and the recent abandonment of the 'zero tolerance' Covid-19 policy in China. If the expected slowdown turns out to be no worse than a typical mid cycle slowdown, the global economy should have begun to recover by the second half of the year, with an improving growth trajectory into year end.

Having hit new year to date lows in October, equities seem to have almost fully factored in the aggressive tightening cycle by central banks and the significant rise in bond yields. Equities now appear attractive, with global price/earnings multiples below long term averages. However, equities may not yet have fully discounted the extent of the slowdown in growth and associated impact on earnings, with further downward revisions to earnings forecasts expected.

Looking forward, while a further slowdown in growth or even recession might be evident in the major developed economies by the middle of this year, it is still realistic to expect global growth to be on an improving trend as we exit 2023. For the year as a whole, the global economy could grow 1.8% with solid growth in emerging markets offsetting weakness in developed market regions. However, as we exit 2023 and the recovery phase of the next cycle begins, global growth could be on an improving path, trending higher at a rate of over 2% by year end.

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World GDP Forecasts

	2021	2022 (forecast)	2023 (forecast)	2024 (forecast)
World	6.0%	2.9%	1.8%	2.2%
Ireland	13.7%	5.0%	2.5%	3.2%
United Kingdom	7.2%	4.1%	-0.3%	0.3%
Eurozone	5.4%	3.2%	0.5%	1.4%
United States	5.7%	2.0%	1.0%	1.4%
Japan	1.8%	1.2%	1.6%	1.0%
China	8.1%	2.5%	6.0%	5.0%

Source: Bloomberg 31.12.2022

2023 Investment Outlook – Ireland & the World

Ireland

The Irish economy performed strongly in 2022 based on the recent quarter three GDP release, growing 11.7% year on year. However, GDP is distorted by the multinational sector and Modified Domestic Demand (MDD) is viewed as a better measure of underlying demand in the economy. While MDD grew 10.1% in quarter three, it was down -1.1% quarter on quarter as domestic investment and government spending fell, while consumption grew a modest 0.3%. The recent slowing in growth reflects the squeeze in real incomes from higher inflation, the impact from tighter European Central Bank monetary policies and the impact of the war in Ukraine, all of which have been evident across the whole of Europe.

In quarter three, the industrial sector excluding construction grew 9% while the information and communication sector, also heavily dominated by multinationals, fell -7.4%. The agriculture, forestry and fishing sector grew 13.6%. Government spending was down -0.3% as Covid-19 related expenditure continued to fall. Other sectors in the economy performed as follows:

* *Real estate was up 1.2%*
* *Finance and insurance fell by -5.2%*
* *Construction activity rose by 0.9%*
* *Exports rose 4.8% and imports were up 27%*
* *Professional and administrative services were down -2.5%*

The Irish economy proved to be relatively resilient in 2022 with business sentiment surveys generally holding up better than the rest of the Eurozone. The trade sector remained strong given the defensive nature of the export base and consumption grew 7.2% to the end of quarter three, supported by record levels of employment, strong consumer balance sheets and the still relatively high savings rate.

In the labour market, unemployment has fallen to 4.4% compared to 4.8% immediately prior to the Covid-19 pandemic, with a record 2,554,000 people employed. Household net worth has risen to a record €1025bn, while household debt to disposable income has fallen to 95%, from a peak of 210% before the Global Financial Crisis.

Inflation remains high at 8.9% although it is down from a recent peak of 9.2% and is expected to moderate further in the coming months. Consumer confidence has fallen below Covid-19 lows with the squeeze in real incomes from higher inflation, although this has begun to recover as inflation eases.

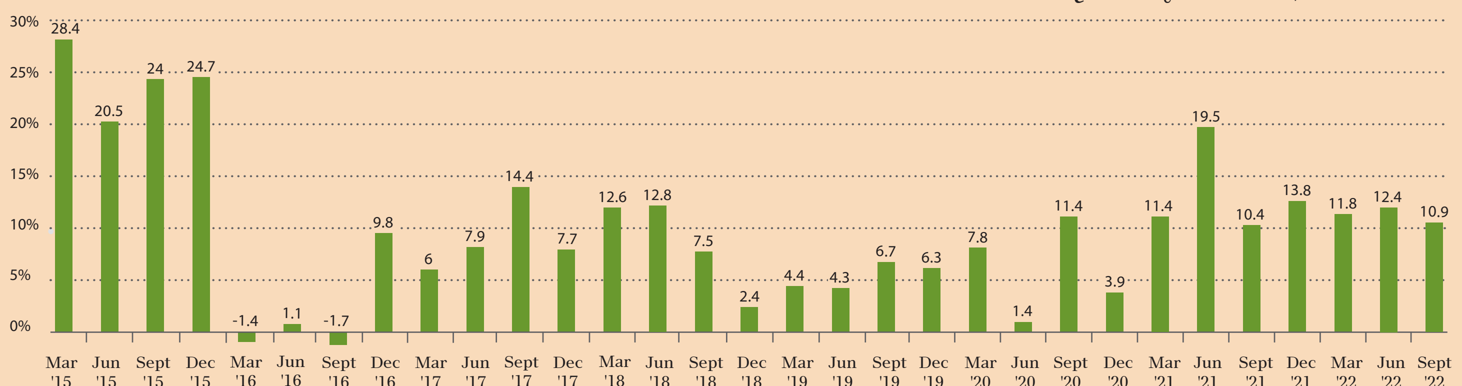
The key risk to growth remains developments in the global economy, where there have been increasing concerns over a possible recession in 2023 due to higher inflation, tighter monetary policies and geopolitical events. 'Brexit' also remains an ongoing concern, although the new UK Prime Minister, Rishi Sunak, appears to want to adopt a more cooperative approach with the EU, which has somewhat reduced tensions. Growth forecasts for 2023 have been trending down as they have been elsewhere but remain above those in Europe and most other developed markets at around 2.5% for the year.

Europe

While the European economy is seen as the most sensitive to the fallout from the war in Ukraine, growth proved to be relatively resilient in 2022. Despite being buffeted by a surge in gas prices and disruptions to supply chains due to the war, the Eurozone economy is estimated to have grown by 3.2% in 2022. A boost from the reopening of economies after the pandemic, together with the announcement of significant fiscal support measures for consumers and businesses to offset energy price pressures, has resulted in growth exceeding initial expectations after the outbreak of war.

Growth however has subsequently slowed and the Eurozone economy is thought to have entered recession in the fourth quarter of 2022. Retail sales and industrial production have fallen into negative territory while business sentiment has also fallen to recessionary levels. Consumer confidence also reached new record lows in the second half of the year. However, sentiment and activity levels have recently begun to improve as gas prices have fallen back to levels seen before the war. Hopes have also grown around the reopening of the Chinese economy in 2023, which should be beneficial for Europe. As a result of these developments, the current recession is now expected to be milder than originally feared, with growth predicted to return to positive territory by quarter two and growth of 0.5% to 1% expected for the year.

Irish Quarterly GDP Year/Year Growth



Source: Bloomberg 31.12.2022

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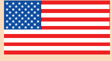

United States

The US economy was expected to grow 3.7% in 2022 but as elsewhere, forecasts have been cut, despite the relative resiliency of the economy given its reduced sensitivity to events in Ukraine. With interest rate rises, lower global growth, reduced consumer and business confidence and the drag from higher inflation, the US economy is now expected to have grown 2% in 2022.

Within the economy, activity levels generally remained firm throughout most of the second half of 2022, although they did weaken somewhat into year end. The labour market has continued to stand out as the key area of strength, with unemployment falling to 3.7%. Despite this, consumer confidence levels remain low.

US inflation appears to have peaked, falling from a high of 9.1% to 6.5%. The US Federal Reserve has aggressively tightened policy to combat higher inflation. This has negatively impacted the housing market which has begun to weaken, as has business sentiment. Growth is expected to slow in 2023 to around 1%.

The US Federal Reserve has outlined its determination to bring inflation back to its target of 2%, having raised interest rates in 2022 and guiding to further rises. It has acknowledged there will be economic pain because of its policy actions. It has indicated that it expects to achieve a soft landing and avoid a recession, although it has admitted this will be a difficult task and has suggested risks of a recession have somewhat increased.

*Rebased to 100 as of 02/01/2018

Source: Bloomberg 31.12.2022

China

Having been expected to grow by about 5% at the beginning of the year, Chinese growth in 2022 is now estimated to have only been around 2.5%. Recent economic releases highlight a significant weakening in growth. In December, for example:

- *Retail sales were down -5.9%*
- *Industrial production growth slipped to 2.2%*
- *Fixed asset investment growth eased to 5.3%*
- *Property investment was down -9.8%*

Given the economic struggles, the Chinese authorities decided to abandon their 'zero tolerance' Covid-19 policy and effectively fully reopen the economy. This has caused a surge in case numbers and will likely result in growth remaining weak in early 2023, as activity is disrupted by rising infections. Thereafter, growth should rebound strongly, as was evident in developed economies when they moved to 'living with Covid-19'. The authorities have also committed to supporting the economy and the important property sector through fiscal and monetary measures, all of which should mean a strong recovery in 2023, with growth of around 6% expected.

Japan

The Japanese economy has continued to struggle as pandemic related restrictions remained in place longer than elsewhere. Activity and sentiment have recently begun to improve as restrictions have finally been lifted, suggesting a strong recovery in growth in 2023.

Inflation has been lower than elsewhere but has risen to 3.8%, above the Bank of Japan's target of 2%. Following the rise in inflation, the Bank of Japan has begun to tighten monetary policy. Ongoing fiscal support to offset the impact of Covid-19 provided a boost to the Japanese economy in 2022 with the fiscal deficit forecast to rise from 5.5% of GDP in 2021 to 6.7% in 2022. Fiscal support is expected to ease in 2023 as the economic recovery becomes more self-sustaining.

Recent economic releases confirm an improvement in growth. With strong underlying growth as the economy moves into 2023, it is forecast to grow 1.6% this year, an improvement from 1.2% in 2022.

The 60/40 Portfolio – An Outdated Strategy?

The 60/40 portfolio is a default investment strategy which has been used by investors for decades and served them well in the past. This article investigates whether this 'balanced portfolio' continues to be a viable strategy for today's investors and explores some alternative options.

The 60/40 model is composed of a fixed allocation of 60% equities and 40% bonds, and it has long been a trusted strategy, with historic data going back over 100 years. This 'balanced portfolio' performed well throughout the 80s, 90s and 2010s. It has been particularly popular among retirees, as the mix could usually support annual withdrawals of 4% without eroding the original capital.

The equity allocation of a 60/40 portfolio is intended to provide capital growth and income, whilst the bond allocation offers fixed income and risk mitigation. In times of growth, equities would perform well but with high volatility, whereas bonds provided lower returns but steadied the ship. The 60/40 portfolio performed extraordinarily well during the period following the Great Financial Crash of 2008 & 2009, as global central banks reduced interest rates to counter the threat of deflation. Falling interest rates are good for bond values and good for most equities, therefore both sides of the model benefitted concurrently.

Intermittent Growth

The trend of lower interest rates has been dramatically reversed since the start of 2022 as inflation spiked, resulting in a swift increase in interest rates. Increased rates have devalued bonds and led to a significant fall in equities. Rather than balancing each other, both sides of the 60/40 proposition fell simultaneously.

The 60/40 portfolio has enjoyed good but intermittent growth. Investors would have done well from it in the 90's and '10s but would have been sorely disappointed with its performance in the '00s, which would not have supported a 4% annual withdrawal. The timing of an investment is also very relevant to the outcome, which is wholly at the mercy of unforeseeable market movements.

Performance and Recovery

The 60/40 portfolio has been quite resilient. Of the 34 calendar years' performance, only 8 of these have been negative, and with one exception, a drawdown has been followed by a good rebound the following year.

Returns Outlook

The global economy is currently slowing down. Long term growth expectations for equities and bonds are below what was previously expected and so the growth outlook for the 60/40 portfolio is similarly reduced. That said, as markets tend to price ahead, many commentators feel that a lot of the negativity has been priced in already and we are potentially nearing the bottom of the cycle. Equities have been revalued downwards and high-quality government bond yields, for example the German 10-year bond, are yielding higher than a year ago. This is good for the prospects of new 60/40 investors, but existing investors have had a more difficult journey.

Alternative Options to 60/40

There are ways to potentially enhance returns within the 60/40 structure, however, they come with higher risks and costs and do not address the "volatility of the volatility" of the 60/40 portfolio.

Active Management in Equities and Bonds: Active managers may possibly enhance returns over passive ones but may come with extra risk and cost.

Niche Markets in Equities and Bonds: Niche markets such as Small Caps and Emerging Market Equities or High Yield Bonds and Emerging Market Debt might provide extra sources of return but again bring extra risk and costs to the portfolio.

Factor Investing: Fund managers screen to isolate stocks with certain attributes to pursue better returns. Common factors screened for are Growth, Value, Quality and latterly, companies exhibiting good Environmental, Social and Governance (ESG) behaviours.

Alternative Assets	*Commodities, Infrastructure, Private Equity*
Alternative Strategies	*Hedge Funds, Absolute Return Strategies, Long/Short Strategies*

The multi asset portfolio manager will generally use alternatives that have a low correlation to equities and bonds as an additional source of risk control and return. The asset class individually may underperform an equity fund in a booming market, but it can outperform in a falling one, thus smoothening the performance of a mixed asset portfolio. Alternatives can therefore improve the risk profile of a portfolio and add return when markets may be unfavourable.

Summary and conclusion

The 60/40 portfolio has served investors quite well in the past. Recent downward asset revaluations make the proposition attractive currently, but it is questionable whether it can deliver strong, consistent performances in the future. Volatility remains elevated in bonds and equities as the push/pull battle between curbing inflation and maintaining growth plays out and 60/40 investors are exposed to this volatility. Multi asset managers routinely add alternatives to Equity/Bond portfolios such as the 60/40 portfolio to improve long-term risk adjusted returns and reduce the risk of large drawdowns.

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