
# INVESTMENT OUTLOOK Q1-2023

## DIVERSIFY: GREATER POSITIVITY BUT EXPECT TURBULENCE

Aim for maximum diversification to protect capital while increasing the number of potential sources of return. Our thoughts remain with those affected by the war in Ukraine.

The great rebalancing of asset prices in 2022 meant there were few places to hide in markets last year. As investors, we should always remember that enduring these periods is vital to achieving our investing goals, and that over a long-time horizon, these upsetting periods fade in significance. The one prerequisite for achieving our objectives when putting money away, is that we stay the course and stay invested in a sensible and risk-conscious way. This can often be easier said than done. Significant movements in markets can often provoke reactions that ultimately destroy capital when, in fact, realising that inaction can be an active and reward-bearing choice.

Looking ahead – and starting with our outlook for bonds – we have seen a massive adjustment in the yields and prices of bonds over the past year. The yields on UK and US 10-year bonds have roughly doubled since the start of 2021 (a move that many thoughts could not happen). These yields are important as they provide a good indication of long-term borrowing costs for the least risky borrower in the market — namely the respective governments. While the price movements in 2022 were unnerving, the current yields on offer from developed market bonds now offer decent value both in terms of income (yield) and potential price appreciation. Indeed, yields (income) now offer some cushion to any further price dips. We are constructive on bonds at these levels, which is why we are at our maximum allocation across our Plans. In terms of the bond exposure, we remain tilted towards shorter maturity bonds for now. We are actively monitoring economic developments – both at home and abroad – for opportunities to increase our allocation to assets with greater maturities, which would benefit more from rate decreases. We are nearing the end of the rate hiking cycle and, once the constraining effects take hold on economic growth (and in turn inflation), we think the time will be ripe for longer maturity bonds as investors seek safer assets (i.e., those issued by the most trusted central banks and governments).

Why will they seek safer assets? The answer lies in the corollary. Weaker economic growth –and we think a mild recession – brought about by the steepest interest rate hiking cycle in memory, is likely to shrink profits and dry up jobs. This will undoubtedly be negative for shares, which rely on growing or sustainable earnings for their value. It is for this reason we are very cautious on shares at this stage of the cycle and think that a negative economic environment has not been fully priced into shares just yet. For this reason, we have tilted more in favour to developed markets, where we prefer the US and UK for their defensive and valuation qualities, respectively.

## SLOW, STEADY AND BALANCED WINS THE RACE

While inflation seems to have peaked, many risks and unknowns remain. We have witnessed the steepest rate hiking cycle in a generation, and there remains considerable uncertainty around when and how this will affect the global economy. Added to this, there are a plethora of real and near-term risks around the world. Owing to this, we have sought to maximise diversification by taking advantage of renewed value in bond yields, while introducing a far greater allocation to alternative assets such as infrastructure. We have tilted towards more established share markets as a defence against riskier share markets, while maintaining a cash buffer to mitigate against losses and to provide fire power if share prices take a downward turn. While this may mean on missing out on the odd false rally – we think the market and global environment is one that requires caution – slow and steady wins the race.

This document has been prepared by Wealthify's Investment team and the opinions expressed here are theirs.

## TOP RISKS

**Global Recession**
Central banks' steep interest rate hikes have heightened policy error risk and, in turn, the risk of a greater-than-expected economic and corporate profit downturn.

**Debt Crises**
Geopolitics, soaring inflation, and fiscal policy errors increase the risk of credit downgrades and crises, fuelled by debt sustainability concerns.

**Russia Ukraine Crisis**
With no end in sight, the threat of escalations remain, as the war squeezes commodity and energy markets.

**Europe**
A full cut off in gas supplies would fuel an energy crisis, and deeper recession.

**New covid-19 variants are vaccine resistant.**
While the world – including China – have adopted a 'live with the virus' approach, risks of new variants and collapsing health systems remain.

**China**
Regulatory crackdowns and property market troubles remain an issue. Relations with the US remain an ongoing threat to global economy.

**Post-Brexit UK**
The UK's evolving trade relationships still weigh on investor sentiment.

| INVESTMENT TYPE | OUTLOOK | RATIONALE |
|---|---|---|
| **SHARES** | | We are cyclically underweighting shares due to the potential for earnings disappointments as a result of a deteriorating economic backdrop. |
| UK | + | Both small and large UK companies generate significant amounts of their earnings offshore, which provides insulation against the negative impact of local political and economic environment. We are positive on the FTSE 100 and FTSE 250 for different reasons: the FTSE 100 offers access to defensive sectors, while the FTSE 250 is historically cheap – both good qualities in economic slowdown. |
| US | + | We are positive on US equities as they offer access to more resilient, diversified and defensive business models and sectors. We have also seen a large valuation contraction which increases potential returns, given the solid underlying fundamentals relative to other markets. |
| Europe ex UK | - | Europe's energy problem remains live along with soaring inflation. Both are a threat to the region's economic growth as policy makers raise rates aggressively. We don't think the downturn and risk of a deeper downturn are currently priced in making the region relatively unattractive. |
| Japan | = | Japan's economic environment remains pedestrian as the effects of Covid restrictions linger. Easy monetary policy has seen a strong devaluation in the yen. The possibility of recovery is decent given the low sentiment, but a lot hinges on the global (US) economic environment. |
| Emerging Markets | = | Excluding China, EM look to be in decent shape both in terms of pricing and underlying fundamentals – but does remain at risk in the event of a global recession. In addition, the unstable political and property market in China grounds optimism on the relaxing of Covid restrictions. |
| Asia Pacific ex Japan | = | The region is geographically and economically removed from the conflict in Europe, whilst inflation is less of an issue. It's likely to be a benefactor from an improving China story. Despite this we remain neutral due the highly uncertain path ahead for China. |
| **FIXED INCOME +** | | We are cyclically positive on bonds due to the improved yield environment and defensive nature of bonds in a slowing and negative economic environment |
| **Government bonds** | | |
| UK | + | UK government bonds (gilts) have been through a sustained period of negative performance, as rates increased rapidly on the back of soaring inflation. With much of the rate hiking cycle behind us, gilts offer attractive upside potential with low downside risk. |
| US | + | US government bond yields have increased dramatically over the past year. While we may see a final leg up in yields, they offer attractive upside potential and protection in the case of a recession. With much of the rate hiking cycle behind us, little downside risk remains. |
| Europe ex UK | = | We remain neutral as we continue to monitor the outlook for this asset class against a very uncertain geopolitical and economic backdrop, where strong ECB interest rate hikes have increased the risk of policy error. |
| Japan | - | Despite a decent increase in yield and policy cap, Japanese bonds offer little income and remain severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change. |
| Emerging Markets | - | While EM government bonds offer a strong yield premium compared to Developed Markets, we remain slightly negative given the potential for a US recession, which would see a flight to safety and a stronger US dollar. |
| **Corporate Credit +** | | |
| UK | + | We have a positive outlook on UK investment grade credit, owing to the strong yields and broadly solid fundamentals within a more stabilised interest rate environment. |
| US | = | Our outlook for US investment grade credit has dimmed somewhat as valuations have realigned with long-term averages. |
| Europe ex UK | - | We remain slightly negative on European credit owing, to the many risks that remain such as high inflation, weak growth, and geopolitical tensions. |
| Japan | - | Like Japanese government bonds, Japanese corporate bond prices offer very little in income. |
| **ALTERNATIVES +** | | We are positive on alternatives over the long term |
| Environmental | + | Companies focused on reducing their environmental impact often have a competitive advantage due to greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits. |
| Global Real Estate | + | After a tough 2022, which saw fundamentals take a back seat to concerns over rising rates, global real estate offers attractive value underpinned by improved rental income streams. Due to the nature of leases, real estate provides decent inflation protection. |
| Global Infrastructure | + | The long-term outlook for Global Infrastructure remains positive with a global need for advancement and investment. The asset class also offers exposure to stable revenue streams which make it defensive in nature. Due to the nature of leases, real estate provides decent inflation protection. |