2023 INVESTMENT OUTLOOK

A world in transition

Slowing down to get back on track

Omnis INVESTMENTS

Robert Jeffree
Chief Investment Officer

The year ahead

2022 will go down as one of the most challenging years for investors. A global pandemic in 2020 brought the world to a halt, with governments providing financial support for their economies and people. 2021 was characterised by the reopening of global economies and a year of strong economic activity.

The post-pandemic boom triggered supply-chain challenges. These, together with a generous fiscal response (government support) to the pandemic – particularly in the US – led to inflationary pressures. Russia's invasion of Ukraine exacerbated the issue as energy prices rose sharply across the globe.

With inflation rising rapidly, central banks around the world began raising interest rates, leading to huge falls in equity and bond markets. 2022 was a big reset for the world and its financial markets.

Economic growth and inflation

As we head into 2023, we believe two key areas will dictate how markets behave – economic growth and inflation. Over the next few pages we set out where we believe we are heading on both these metrics and what it means for different asset classes. We also look at other factors that could impact markets in 2023.

Although it's important to consider the outlook for the year ahead, investing requires a long-term horizon. Despite shorter-term challenges, the long-term outlook for financial markets has improved significantly.

We hope you find this report insightful and, as always, please speak to your financial adviser if you have any questions.

The global economy is slowing

A recession appears likely in most developed economies, but the scale will vary across the globe.

The pace of economic growth around the world has been slowing for a while now. Some regions are likely to fall into recession during 2023, and there are three main causes:

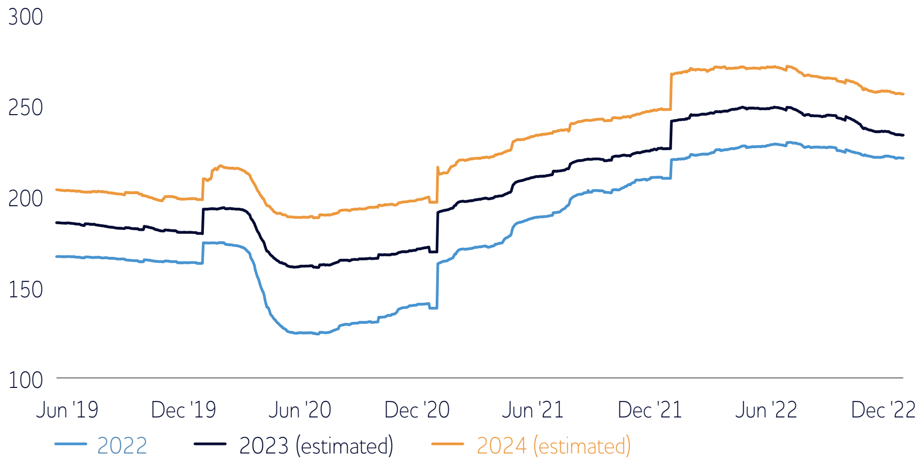
1. The boom in demand for goods during the Covid pandemic and subsequent boom in services when the lockdowns ended are now fading as consumers revert to more 'normal' spending patterns.
2. Record-high rates of inflation and falling stock markets have eroded disposable household incomes and savings. As a result, consumers are tightening their belts and spending less.
3. Higher interest rates are starting to make themselves felt via the cost of borrowing. For example, UK mortgage owners are looking at sharp increases in monthly payments, more companies are reporting that loans are difficult to obtain, and consumer credit card balances are rising.

A challenging year ahead

With consumers tightening their belts, can companies really pass on the increased costs they are facing to consumers? We think this is unlikely and therefore believe corporate revenues and profit margins will fall this year, which is something that has not been taken into account yet (figure 1). Share prices are linked to earnings and are therefore likely to drop too. However, the good news is that stock markets did some of this work last year, with share prices falling as investors worried about inflation and rising interest rates.

Figure 1: Earnings per share forecasts for 2023 and 2024

Investors are expecting company's earnings to increase this year and in 2024. Yet as economic activity continues to slow, we believe these expected earnings will be revised downwards.



Source: Bloomberg.

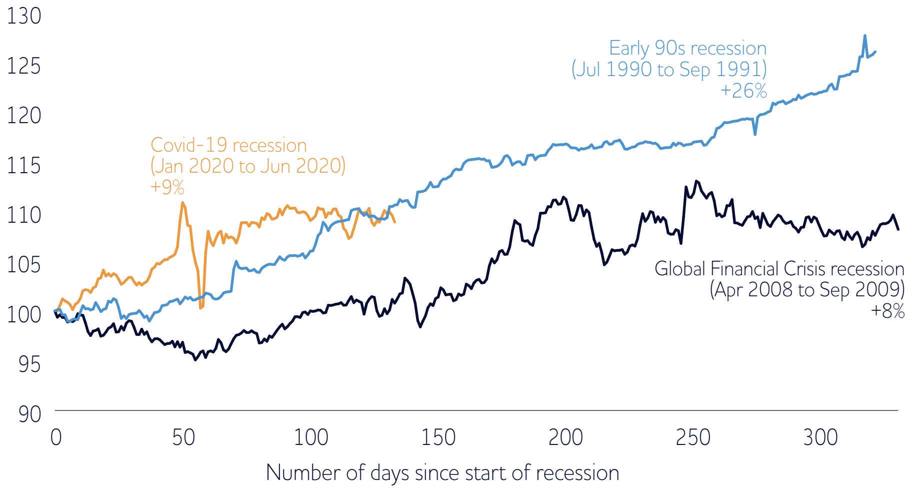
Investment implications

Our central case is that the global economy will head into a recession in 2023 (some areas might already be in a recession). A recession means the pace of economic activity is falling and they are usually negative for equity markets, but favour good-quality government bonds, such as Gilts (issued by the UK government), Treasuries (US government debt) and Bunds (German government debt).

As investors flee from equity markets due to falling company earnings, they tend to seek more stable and safer investments. An increase in demand for government bonds pushed their prices up, which is something we have seen in previous recessions (figure 2). In the meantime, after a torrid year in 2022, bond investors now receive a healthy income yield while they wait.

Figure 2: Gilts deliver positive returns through recessions but don't move in a straight line

This chart shows UK gilt returns from the day before the UK entered a recession (indexed to 100) until the day after the recession ended.



Source: ICE BofA UK Gilt Index from Bloomberg.

Within equities, there are still areas of the markets that will do better than others. Typically, these are more defensive companies such as utilities, companies producing or selling essential goods and healthcare organisations. It's also worth remembering that in the past, equity markets have begun rising before a recession is over. Continuing to include equity investments in your portfolio is important.

Although economic activity is bound to drop, the global economy could avoid a prolonged recession. A few examples of how this could be achieved include:

- The reopening of the Chinese economy boosts global growth.
- The US central bank, the Federal Reserve (Fed), is able to raise interest rates enough to quash inflation but not drive the economy into a recession – a very tricky balancing act.
- A peaceful resolution of the Russia–Ukraine conflict, and further falls in energy and food prices.
- Consumers who saved during the pandemic, begin spending, therefore boosting the economy.

Although we think the likelihood of completely avoiding a recession is low, it's worth considering what it could mean for the different parts of your portfolios. Yet again, government bonds are likely to perform well because inflation and interest rates would be expected to fall.

Stock markets and good-quality corporate bonds (debt issued by companies) should also perform well because a recession has been avoided. Sectors that would do well in this instance are industrials and high-end consumer goods businesses. Boosted by the reopening of China's economy, regions exposed to its recovery should also perform well. They include Australia, Europe and some emerging markets.

This is another reason why it's important to have a diversified portfolio – it allows for different investments to perform well in different environments.

Summary

We believe global economic activity will continue to drop in 2023 and a recession is highly likely. Government bonds provide a helpful buffer as prices go up with the demand for them increasing. Equities may struggle in the very short term but should begin to recover well before the recession is over.

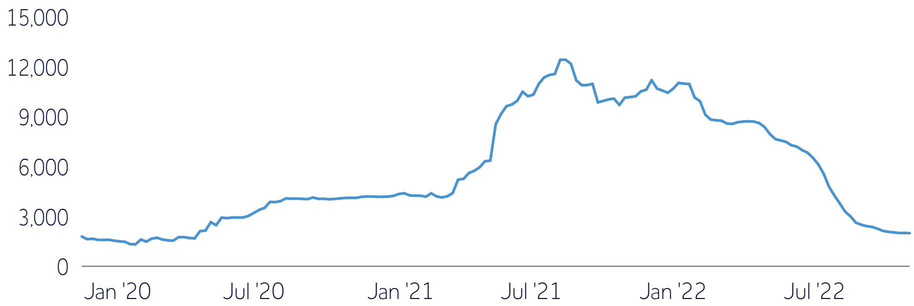
Which way next for inflation?

Inflation appears to have peaked and investors expect interest rates to stabilise or even fall in 2023, but risks remain.

We expect inflation to fade throughout 2023 for various reasons. The first is mathematical – last year's large increases in energy costs will fall out of the annual calculations. The second is that corporate profit margins are falling to levels that are more consistent with the past. The third is supply chains settling back down to more typical patterns, with shipping costs falling and delivery backlogs clearing (figure 3).

Figure 3: Shipping costs have fallen sharply

The cost of shipping a 40 foot container from Shanghai to Los Angeles (in US dollars) rose rapidly as economies reopened following the pandemic, but have since fallen significantly.



Source: Bloomberg.

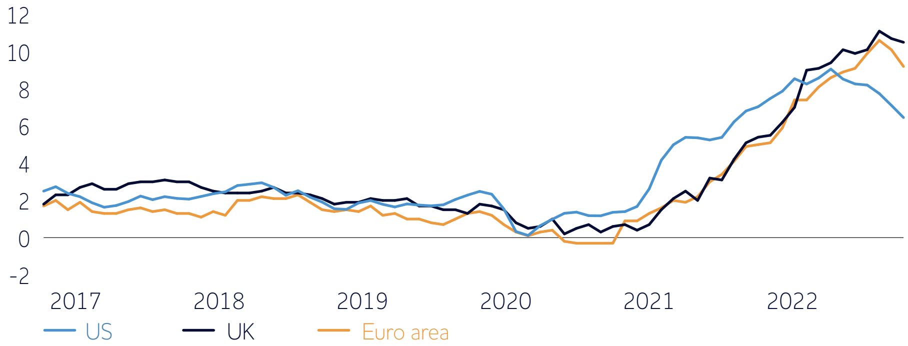
However, cost-of-living pressures are likely to persist. Prices increased by more than wages last year, so incomes have fallen in real terms. At the same time, energy prices have risen, food prices are high, tax burdens have increased (notably in the UK) and many people with mortgages face higher monthly repayments.

As a result, disposable incomes have plummeted. Consumers have less to spend on non-essential goods, which is a significant challenge to developed market economies where the majority are highly dependent on consumption to fuel their growth.

However, fading inflation means the outlook isn't as bad as it appeared a few months ago (figure 4). Falling energy prices and a milder winter have been a particular help for the UK and Europe. While government support in the UK is due to be slashed in April, lower energy prices make this move less catastrophic for households. The energy price cap is even expected to fall towards the end of the year.

Figure 4: Consumer price indices

Inflation appears to have peaked in most major regions (%).



Source: Bloomberg.

What about China reopening? The country's economic policies and rate of growth have diverged from the developed world. A rebound in its domestic consumption is possible as households spend their stockpiles of savings. China's economy is likely to grow when the rest of the world is struggling so it has a better chance of expanding without pushing up inflation.

Interest rates

Financial markets expect US interest rates to peak at just below 5% by the middle of 2023 and then fall to almost 4% by January 2024. The forecasts rely on inflation falling without pushing the economy too far into recession, which would allow the Fed to slow down the pace at which it raises interest rates, and perhaps even to cut rates in the second half of the year.

We're not so convinced. Although US interest rates are probably approaching a peak, we don't expect them to fall unless the economic outlook deteriorates substantially. Even if the economy slows but avoids a recession and inflation falls back to 2%, the Fed cannot shift its policy to stimulus mode (which would involve cutting interest rates meaningfully) with unemployment so low.

Investment implications

What's likely to happen in financial markets if inflation fades and interest rates peak? Government bond prices are likely to rise because they tend to go up when investors expect interest rates to come down. It's important to remember that interest rates don't actually have to come down – the expectation alone should boost government bond prices.

Meanwhile, stock market sectors that are sensitive to economic growth could struggle, while more defensive sectors may hold up better. The winners are likely to be the most profitable businesses with the strongest balance sheets that can exploit their weaker competitors. This is why it's important to invest in markets actively. Omnis investment managers actively select each company they invest in, and do not just invest in the whole market.

Summary

We are likely past peak inflation and we expect inflation to fall throughout 2023 – though the pace at which this happens is likely to vary by regions. If inflation falls, investors will expect interest rates to fall too, which benefits government bonds. Within equities, it's important to invest actively rather than to invest in the stock market as a whole.

Geopolitics and climate matters

Many other factors are likely to affect the economy and markets this year, including the pandemic in China, war in Ukraine and the continued focus on climate change.

China

At the end of last year, China began to dismantle its zero-covid policy, which had crippled the economy and exploded into rare public protests. The virus has spread ferociously in the wake of restrictions being lifted, and reports say hospitals are overwhelmed. Uncertainty remains about how the government will balance reopening the economy with managing the pandemic.

The Russia–Ukraine conflict

The ongoing Ukraine War continues to take a heavy toll in terms of lives lost, infrastructure destruction and elevated energy prices. A resolution does not appear to be in sight. How the conflict evolves during 2023 can impact financial markets around the world.

Climate change and sustainability

Climate change will remain a key priority for governments around the world and for the private sector. Governments and investors, including Omnis, are demanding better corporate practices when it comes to climate-aligned objectives and the sustainability of doing business. Companies that take these issues seriously are likely to benefit over those who don't.

The US debt ceiling

US politics presents another risk, particularly negotiations over the debt ceiling, which in previous years has caused temporary shutdowns of the government. We expect the usual posturing from the Republicans and Democrats. US Treasuries are the world's default risk-free asset, and so any uncertainty about the ability of the US government to pay income on its debts could upset global financial markets in the short term. A resolution would restore market stability.

Markets are forward thinking and so are we

Financial markets tend to perk up before economic conditions improve as investors look forward to better days ahead.

Diversify your investments

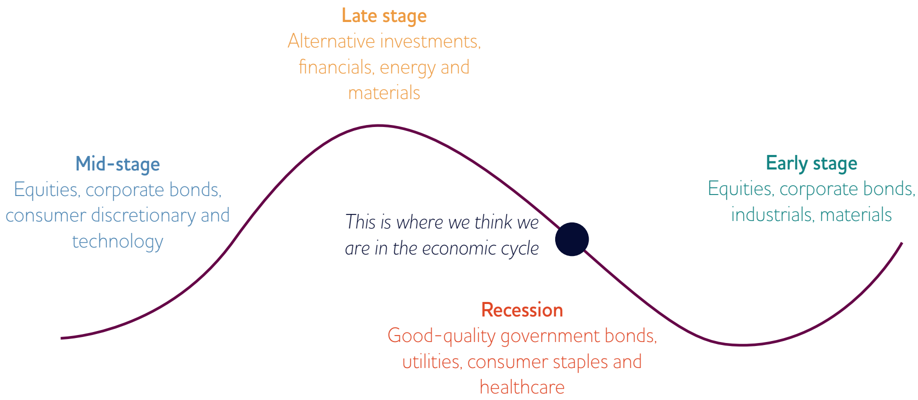
When you invest in a portfolio of Omnis funds, you are exposed to a diversified range of asset classes and regions. Each of the components has a role to play and you will often find that some investments perform better than others at different points in the economic cycle (figure 5).

It is impossible to accurately predict exactly what is going to happen in markets over the next three, six or twelve months. Therefore, it's important to ensure you have enough diversification in your portfolios to account for the uncertainty that comes with investing.

Diversification helps you through market uncertainty. What proportion of each asset class you have in your portfolio will depend on your financial objectives and attitude to risk.

Figure 5: Different assets for different environments

The global economy and financial markets tend to move through a cycle over multiple years.



Source: Omnis Investments.

Beyond 2023

While the economic outlook for 2023 is challenging, it's important to remember that financial markets are forward looking. What this means is that they often start to react many months before economic data becomes more positive. In previous cycles, stock markets have begun to recover before the underlying economy has emerged from recession.

Although we remain cautious on the shorter-term outlook for markets, the longer-term outlook has improved significantly. The sharp falls in equity and government bond markets during 2022 mean that markets now offer the best long-term return opportunities in over a decade*. We always recommend investing with a long-term horizon in mind, which we define as a minimum of five years.

*Source: J.P. Morgan 2023 Long-term capital market assumptions.

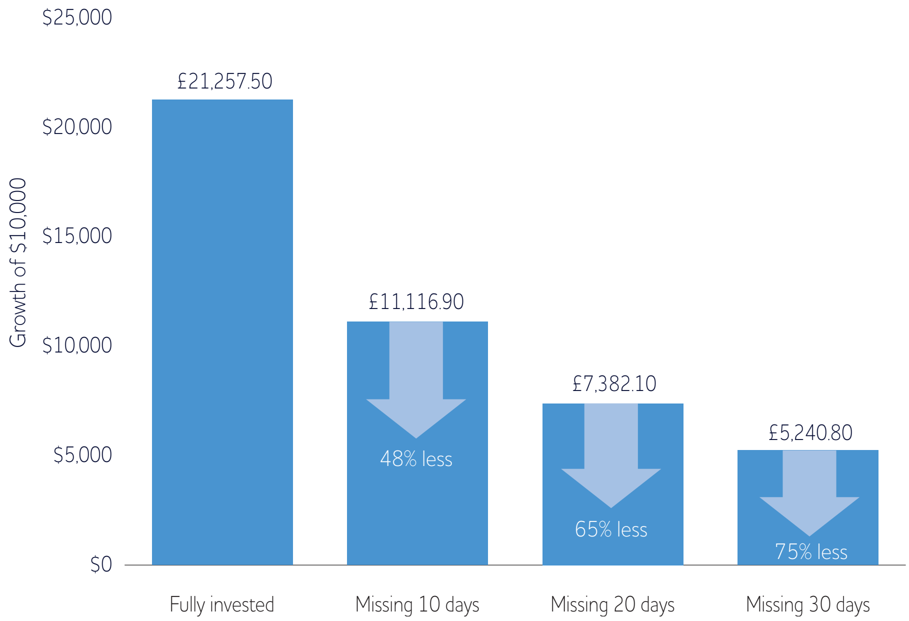
Stay invested

One of the core principles to investing successfully over the long term is the ability to remain calm when markets go through a bumpy ride. Watching the value of your portfolio drop can be difficult and many people get worried and decide to sell their investments in order to avoid any further losses. The problem with this approach is that you'll be making those losses permanent by withdrawing your money at that low point.

Some of the best days in markets tend to come after some of the worst. Any investors who are unable to hold their nerve when markets are falling will not participate in the rebound. The impact of missing out on just a few of the best days can be substantial (figure 6). That's why it's important to remain calm and stay focused on your long-term financial goals.

Figure 6: Missing the market's best days is costly

Returns over 15 years from an initial investment of £10,000 in December 2007 to the end of December 2022.



Source: Bloomberg.

The year ahead is likely to be a challenging one for financial markets. As we navigate through these conditions, it's worth remembering that unless your circumstances change, not reacting to negative news will probably deliver the best results over the long term.

Find out more

We hope that you have found our 2023 investment outlook helpful in understanding the various dynamics at play when it comes to markets and your portfolios. We are optimistic about the longer-term opportunity that markets present to us, while weighing the short-term challenges we should expect.

Over the next 12 months we will continue to update you on our market views and our investment strategies through your financial adviser and our website at www.omnisinvestments.com

As always, we recommend that you speak to your financial adviser if you want to discuss your investment portfolio.