



## Financial market outlook for 2023: First pain, then gain

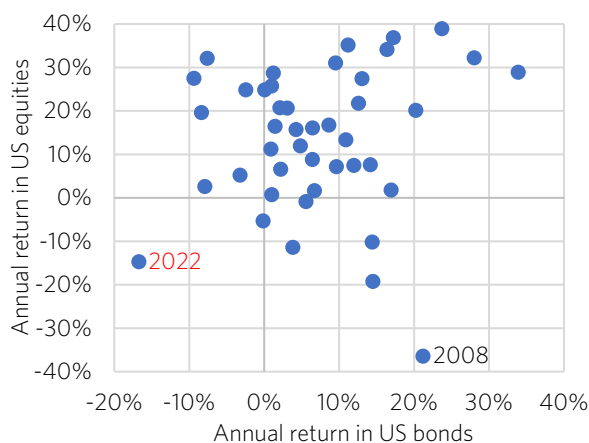
### Highlights

- The interplay between inflation, interest rates and economic growth is likely to determine global asset class returns in 2023. In the absence of further energy or supply-chain shocks, it currently seems likely that global inflation should fall in 2023, led by the United States (US).
- While a slowdown in global economic activity in 2023 seems almost inevitable in reaction to previous policy tightening and the erosion of real spending power, the magnitude of the growth slowdown remains uncertain. A mild slowdown (or so-called soft landing) is certainly still possible, but more indicators (particularly inverted yield curves) are pointing to the increased probability of a global recession next year.
- While global equity markets could be under pressure during the larger part of 2023 as they deal with the potential for recessions and the final phases of rate tightening, there could be some relief for equities towards the latter part of the year as markets start looking beyond the downward growth cycle and begin discounting an eventual Fed pivot to lower interest rates.
- Fundamentally, the anticipated combination of falling inflation and slowing economic growth (with a meaningful risk of recession) should be supportive of the US bond market in 2023. This could re-establish the hedging benefits of having government bonds in a global diversified portfolio, particularly during potential equity drawdown periods amid cyclical slowdown or recession. The significant runup in bond yields in 2022 has once again made fixed income a viable income-providing alternative to equities and made US government bonds look cheap versus US equities.
- Although global property fundamentals remain solid and the asset class looks cheap against equities, its expensiveness against fixed-income assets erodes its relative attractiveness.
- South African (SA) equities have an attractive valuation underpin, both within the global universe and against its own history. This should stand it in good stead during potential global equity drawdowns, but particularly during subsequent recoveries when global risk appetite rises. Even more so, as SA is the fifth most underowned market within global emerging market (GEM) equity funds.
- SA real bond yields are attractive against their own history, as well as relative to those in global markets, with part of the high real yield differential due to a fiscal and country risk premium. We expect falling inflation in the coming year to become less supportive for inflation-linked bonds (ILBs). The prospective SA real cash yield has been rising from a low level in line with policy rate increases and is now only slightly below its historical average.
- Although SA listed property operational metrics are improving, they remain worse than in the pre-COVID era. The potential for meaningful listed property return upside from undervalued levels needs to be weighed against some remaining negative fundamental factors.

## 2022 – The worst of times for global portfolio diversification

Historically, a global portfolio consisting of stocks and bonds on average provided investors with some diversification to protect aggregate returns. Typically, when one of these asset classes performed poorly, the other one performed well enough to ensure at least some positive overall portfolio returns. Most often, positive annual calendar year returns from both US equities and bonds enhanced total portfolio returns (as can be seen in the north-east quadrant of chart 1 from Morgan Stanley).

Chart 1: US equities and bonds annual returns



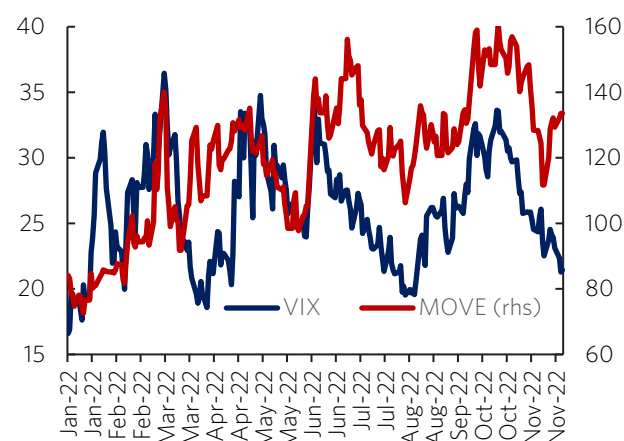
Source: Morgan Stanley

In years when equity returns were negative, positive bond returns often softened the impact on portfolio returns (the south-east quadrant of chart 1), while positive equity returns negated the portfolio impact in the years when bond returns were negative (the north-west quadrant). Not only were there very few times in history when both equity and bond returns were negative in a calendar year (the south-west quadrant), but the magnitude of the negative returns shown by

both asset classes in 2022 are unprecedented and by far the worst in 150 years, according to Morgan Stanley.

The lethal combination of inflation jumping to generational highs and central banks responding by aggressively tightening monetary policy, put both global equity valuations and bond yields under severe pressure in 2022. The elevated uncertainty about the Fed's ultimate policy tightening path due to the continual negative inflation surprises in 2022, catapulted US bond volatility levels (the MOVE index) back to their recent COVID peak, while US equity volatility (the VIX index) rose significantly less (see chart 2). It is thus unsurprising that bonds were unable to fulfil a hedging role for portfolios in 2022. Indeed, there were very few global asset classes that provided significant positive returns in 2022, with commodities (mainly energy) the notable exception, while cash provided only marginally positive returns.

Chart 2: US bond volatility > equity volatility in 2022



Source: Bloomberg, Momentum Investments

## Interplay between inflation, rates and growth to determine global asset class returns in 2023

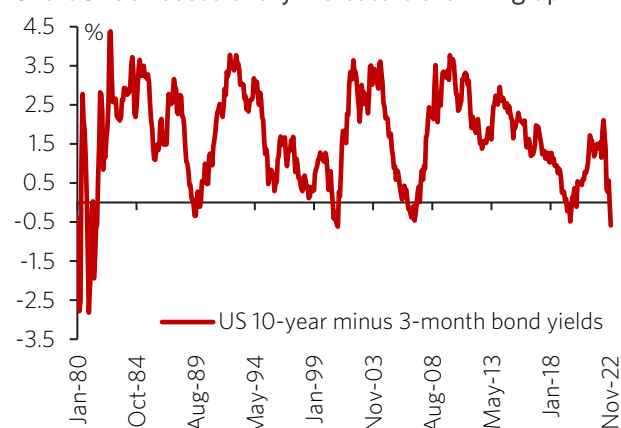
In the absence of further energy or supply chain shocks, it currently seems likely that global inflation should fall in 2023, led by the US. Not only will a very high 2022 base assist the year/year comparisons in 2023 (particularly for headline inflation), but disinflationary trends should be further supported by an already

evident improvement in supply bottlenecks, the erosion of corporate pricing power by high inventory levels and a slowdown in cyclical demand.

While a slowdown in global economic activity in 2023 seems almost inevitable in reaction to previous policy

tightening and the erosion of real spending power, the magnitude of the growth slowdown remains uncertain. A mild slowdown (or so-called soft landing) is certainly still possible, but more indicators are pointing to the increased probability of a global recession next year. Among these, inverted yield curves, as a reflection of tight monetary policies, have increasingly become the norm in many developed economies. In the US, the recent inversion of the three-month/10-year part of the yield curve has historically been an infallible predictor of a US recession within the subsequent 12 months (see chart 3).

Chart 3: US recessionary indicators are lining up



Source: IRESS, Momentum Investments

Cyclical slowdowns or recessions have not been good for growth assets like equities historically. MRB Research shows that recessionary periods since 1970 have been particularly harsh for global equities, with drawdowns during recessions roughly three times larger and lasting around four times longer than those in non-recessionary slowdowns (see table 1). Part of the explanation for the exaggerated poor equity performance during recessions is the outright contraction in corporate profits normally associated with recessionary periods.

Table 1: Peak-to-trough declines during historical global equity corrections

	Mean % decline	Median % decline	Days decline
All corrections	-19%	-12%	220
Non-recessions	-13%	-11%	101
Recessions	-36%	-33%	418

Source: MRB

Should a recession come to fruition in 2023, current US consensus earnings numbers that still anticipate mid-single-digit growth rates for the year will have to be cut well into negative growth territory. Furthermore, research from Bank of America reveals that US equity volatility normally rises during recession years and that the US equity market never bottoms before a recession starts (see table 2). These factors point to the possibility of more downside for US equities in the run up to a potential recession in 2023, unless a recession can be avoided.

Table 2: US equities never bottom before a recession starts

		Days before (-) / after (+) start of recession		Days before (-) / after (+) end of recession
Peak date	Trough date	S&P 500 peak	S&P 500 trough	S&P 500 trough
5 Jan 1953	14 Sep 1953	-207	45	-259
2 Aug 1956	22 Oct 1957	-394	52	-190
3 Aug 1959	25 Oct 1960	-271	178	-126
29 Nov 1968	26 May 1970	-397	146	-188
11 Jan 1973	3 Oct 1974	-323	307	-179
13 Feb 1980	27 Mar 1980	13	56	-126
28 Nov 1980	12 Aug 1982	-245	377	-110
16 Jul 1990	11 Oct 1990	-15	72	-171
24 Mar 2000	9 Oct 2002	-372	557	313
9 Oct 2007	9 Mar 2009	-83	434	-113
27 Dec 2019	23 Mar 2020	-64	23	-38
	Median	-214	204	-108
	Average	-245	146	-126

Source: Bank of America

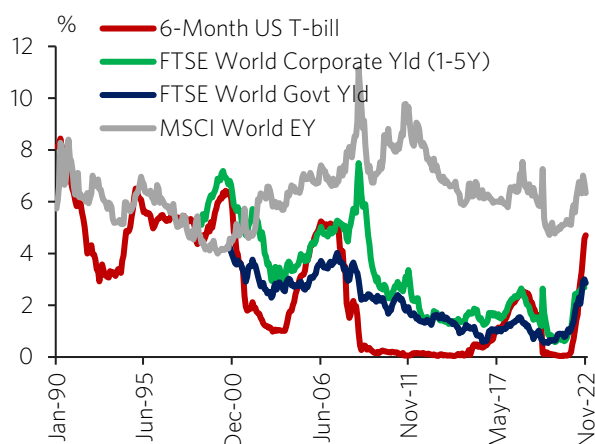
While global equity markets could be under pressure during the bulk of 2023 as they deal with the final phases of rate tightening and the potential for economic recessions, there could be some relief for equities towards the latter part of the year as markets start looking beyond the downward growth cycle and begin discounting an eventual Fed pivot to lower interest rates. This could support equity valuations enough to negate the negative impact of ongoing downward

earnings revisions at the time, igniting an equity market recovery by then.

Fundamentally, the anticipated combination of falling inflation and slowing economic growth (with a meaningful risk of recession) should be supportive of the US bond market in 2023. Research by Morgan Stanley shows that during downturn phases of the US business cycle, US bonds provide better-than-average returns, whereas US equities provide significantly worse-than-average returns. As inflation subsides, this could re-establish the hedging benefits of having government bonds in a global diversified portfolio in 2023, particularly against the backdrop of drawdown risk for equities during downturn/recession periods.

For a long time since the global financial crisis (GFC), fixed-income yields remained so low that investors seeking income for their portfolios had no option but to favour equities, where they could at least get more meaningful income from dividends. This became known as the TINA era, that is there is no alternative (to equities). However, with fixed-income yields shooting up in 2022 to narrow the gap with equity yields (see chart 4), TINA has now evolved to TANYA (there are nominal yield alternatives) and TARA (there are real alternatives).

**Chart 4: Fixed-income yields have narrowed the gap with equity yields**

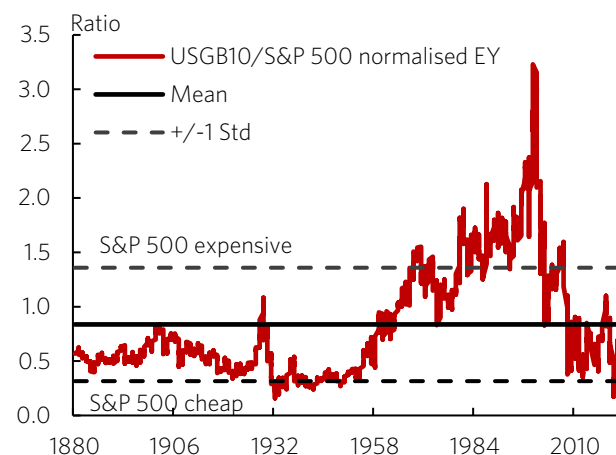


Source: Morgan Stanley

The significant runup in bond yields in 2022 has also now made US government bonds look cheap versus US equities. On a normalised earnings yield gap basis

(using earnings over the past decade), US equities are currently around one standard deviation expensive versus bonds on long-term averages (see chart 5). At the current through-the-cycle earnings yield, US 10-year bond yields would have to fall to around 2.4% to erase the equity valuation premium. Conversely, at current bond yields, US equities would have to fall by around 35% to close the valuation gap.

**Chart 5: Relative US equity/bond valuations**

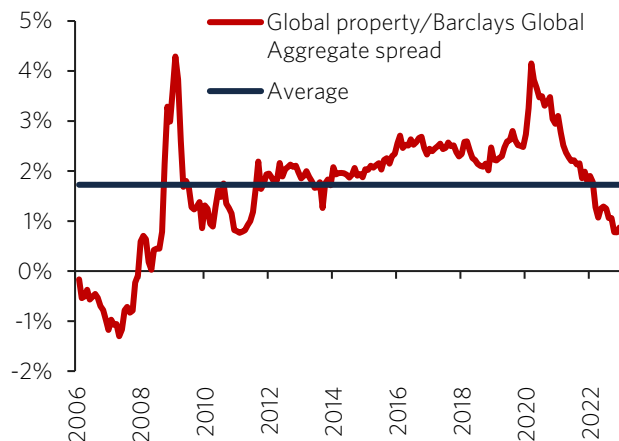


Source: IRESS, Momentum Investments

Global property fundamentals remain solid, with strong US rental growth across sectors outside Office, US vacancy rates outside Office around historical lows and US real estate investment trust (REIT) balance sheets strengthening since the GFC. Not only has REIT sensitivity to interest rates declined since the GFC with the interest cover ratio halving, but REITs have also locked in low interest rates into the future with the average debt maturity profile now more than seven years, from five years in the GFC. Added attractions are that US property historically provided inflation protection to portfolios, outperforming equities during higher inflation periods, while also providing diversification benefits to a multi-asset portfolio.

Global property currently looks cheap against global equities, with an above-average yield spread. However, the global property yield is currently expensive versus fixed-income assets (nominal and real US yields, as well as global investment-grade bonds), with yield spreads below their historical averages (see chart 6), hence eroding the relative attractiveness of the asset class.

Chart 6: Global property expensive versus global investment grade bonds



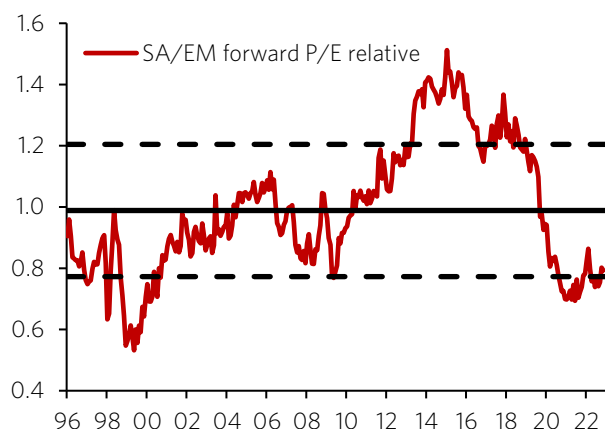
Source: Bloomberg, Momentum Investments

For SA investors, our expectation for some rand appreciation as global risk appetite improves later in 2023, would erode the local currency returns from global assets. Together with the more attractive valuations available from SA assets that provide a high margin of safety, we prefer SA asset classes over global assets in 2023.

## Underowned and undervalued SA equity market has rerating potential

SA equities have an attractive valuation underpin, both within the global universe and against its own history. This should stand it in good stead during potential global equity drawdowns, but particularly during subsequent recoveries when global risk appetite rises. SA equity valuations remain cheap against EM (and even more so against DM), with SA a superior dividend payer within EM and at a large forward P/E discount to EM (see chart 7). Research by SBG Securities highlights that apart from insurance, real estate, banks and capital goods, all MSCI SA sectors are trading at a discount to MSCI EM currently.

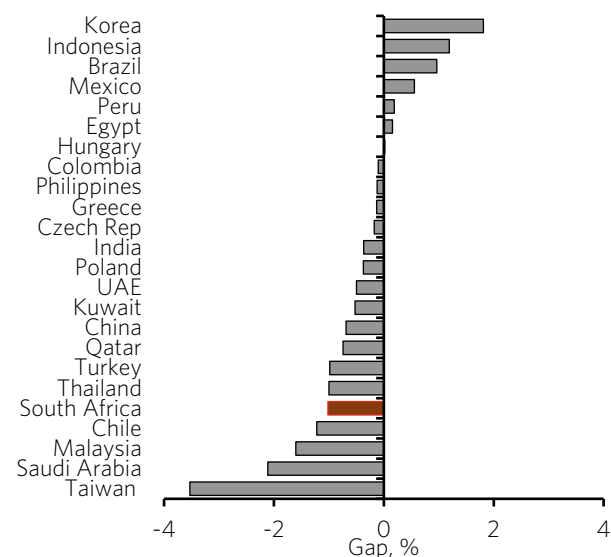
Chart 7: SA forward P/E relative to EM



Source: SBG Securities

Russia's exclusion from EM indices and investor worries about China's investability within EM due to regulatory overreach should benefit the other constituents of EM equity benchmarks. This should be particularly true for SA, which is the fifth most underowned market within GEM equity funds (see chart 8) and as such should have meaningful rerating potential from current cheap valuations when global risk appetite improves.

Chart 8: GEM funds' % allocations to EM countries versus benchmark

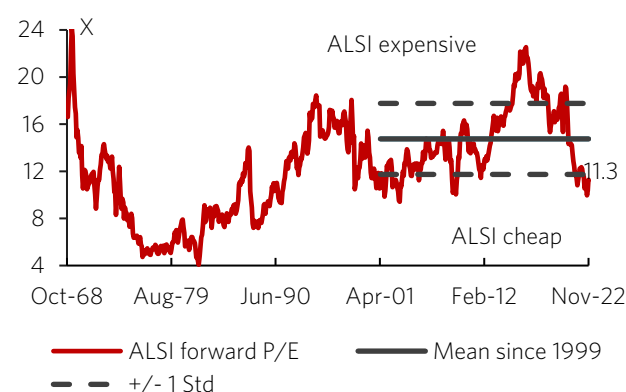


Source: SBG Securities



Even assuming a conservative 6% earnings growth in the next year, the SA equity market is now more than one standard deviation cheap on a forward P/E basis against the average since 1999 (see chart 9). In our view, a lot of bad news is currently priced into SA equities, enhancing the future return potential from current levels.

Chart 9: ALSI forward P/E



Source: IRESS, Momentum Investments

## SA bond yields are attractive in real terms

With global inflation still at very high levels, the real government bond yields available in the developed world remain in significantly negative territory. Although there are inflation outliers like Turkey within EM, in general, inflation rates in the emerging world have lagged those in DM. As such, EM real bond yields based on current inflation rates remain positive in most EM countries, with SA's real yields among the highest (see table 3).

Table 3: Real ex-post 10-year government bond yields

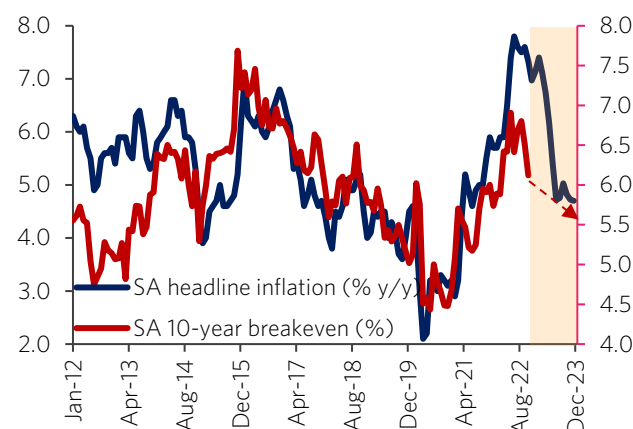
<b>DM</b>	
Japan	-3.5%
US	-4.2%
UK	-8.0%
Europe	-8.2%
<b>EM</b>	
Brazil	6.4%
South Africa	3.9%
Mexico	0.6%
Russia	-2.5%
Turkey	-75.0%

Source: IRESS, Momentum Investments

Not only are SA real bond yields currently attractive versus DM and EM yields, but SA's real yield premiums against DM are also high against historical averages. Furthermore, SA's prospective real yield is also more than one-half of a standard deviation higher than its

own historical average. We argue that SA's high real bond yields already discount high fiscal and country risk premiums.

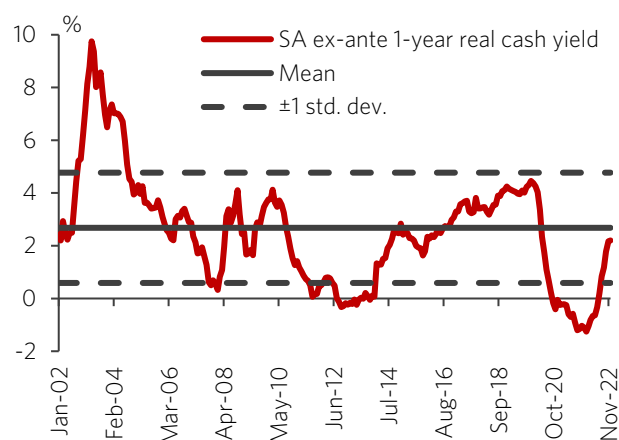
Chart 10: Breakeven tightening expected in line with falling inflation in the coming year



Source: IRESS, Momentum Investments

In the ILB space, we expect some breakeven tightening in line with falling inflation in the coming year (see chart 10). As such, monthly inflation accruals are likely to remain low until Q2 2023, which should become less supportive for ILBs. The prospective SA real cash yield has been rising from a low level in line with policy rate increases and is now only slightly below its historical average (see chart 11).

Chart 11: Prospective SA real cash yield

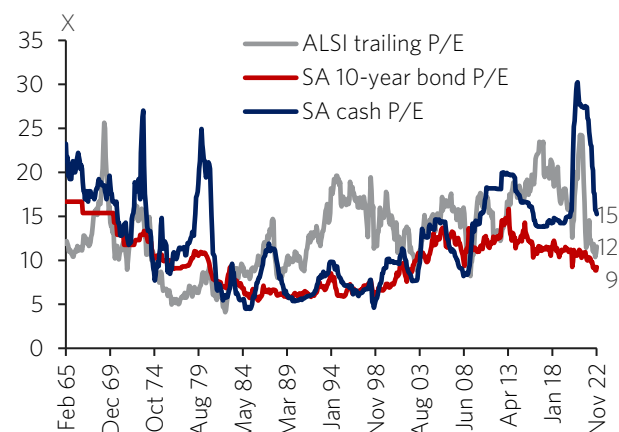


Source: IRESS, Momentum Investments

Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013 (see chart 12). Aggressive COVID-related SARB rate cuts have made cash the most expensive asset

class since 2020, while sharp profit upgrades in 2021 have pushed SA equity valuations sharply down.

Chart 12: SA asset class valuations

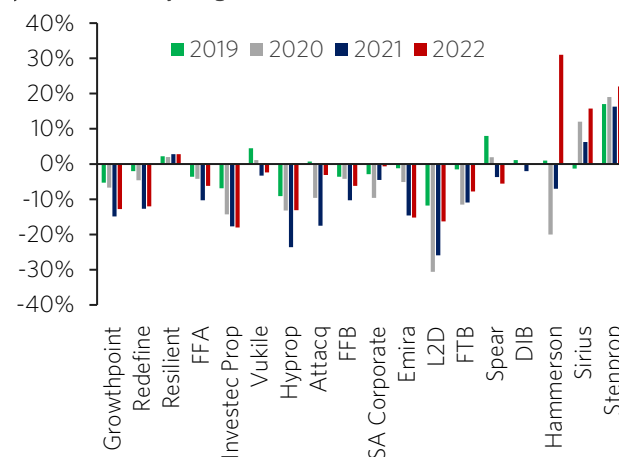


Source: IRESS, Momentum Investments

## Listed property operational metrics improving, but still worse than pre-COVID

Earnings recovery in the SA listed property sector is supported by continued operational improvement outside the office sub-sector, with vacancy rates, rental growth and rental reversions generally improving. But metrics are still worse than pre-COVID and reversions are still predominantly negative (see chart 13), which keep net operating income growth anaemic. At least it seems as if property values have stabilised outside the office sector, with some companies even experiencing rising valuations. From a portfolio construction perspective, the potential for meaningful listed property return upside from undervalued levels needs to be weighed against some remaining negative fundamental factors.

Chart 13: Rental reversions improving, but still predominantly negative



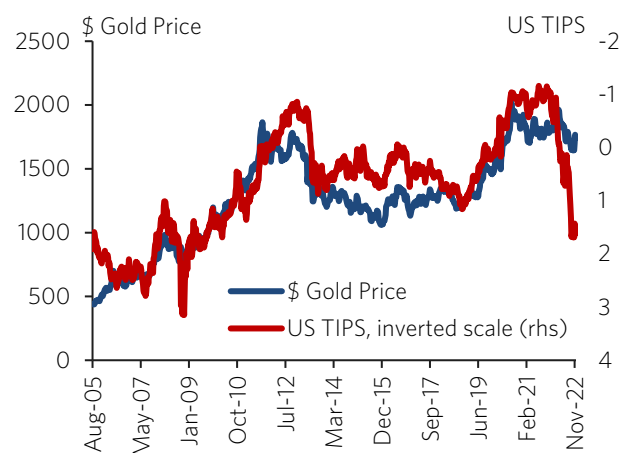
Source: Company reports, Momentum Investments

## Gold price currently too high based on US real rates

With the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset, it is unsurprising that US real interest rates have been the dominant determinant for the US dollar gold price in the last two decades (see chart 14). More surprising has been that movements in the US dollar

does not provide additional explanatory power for the behaviour of the dollar gold price.

Chart 14: US real rates and the gold price



Source: IRESS, Momentum Investments

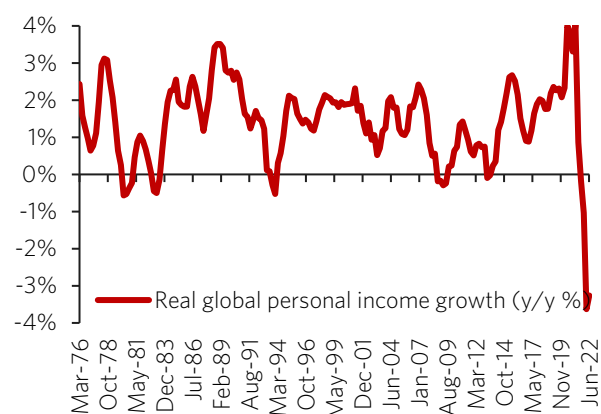
Based on the current level of US real interest rates, the predicted value of the dollar gold price is almost 50% below the current actual spot level. Tactically, gold is thus not an attractive asset class right now. However, we maintain that there is always a strategic rationale for gold as a portfolio risk diversifier due to its safe-haven characteristics during risk-off global bouts, as well as its limited correlation with other asset classes in a portfolio.

## Global and local risks in 2023

An escalation of the Russia/Ukraine war, either into a broader regional conflict (with NATO forced to take a more prominent role) or with some version of nuclear warfare being pursued by Russia, remains a global risk for 2023. Other geopolitical flashpoints could be a more aggressive stance by China on Taiwan, trade frictions between the US and China, renewed provocations by North Korea or altercations in the Middle East.

A further global risk in 2023 would be a widespread upsurge in civil unrest around the world as pressure on the disposable incomes of the general population from sharp cost of living increases (see chart 15), particularly in food and transport, widens inequality levels.

Chart 15: Global real personal disposable income growth under pressure



Source: Dallas Fed, Momentum Investments

Should China persist with its zero-COVID policy in 2023 and fail to re-open its economy on a sustainable basis, global growth will be at risk, while lockdown-related flare-ups in social instability could increase global financial market volatility. An escalation of the credit crunch in China's property sector with broader ramifications for the financial sector would also be destabilising for financial markets.

The US split Congress after the 2022 mid-term elections could cause the approaching debt ceiling to once again be used as a political bargaining tool as 2023 progresses, leading to anxiety in financial markets during the potential standoff periods between the parties.

Policy errors from central banks overtightening policy in response to inflation fears, hence causing severe and extended growth recessions could also disrupt financial markets in 2023.

Within SA, risks to SA economic growth in the coming year from elevated frequencies of Eskom loadshedding, operational issues at Transnet or disappointing progress on economic reforms, would result in an increase in SA's risk premium as an investment destination. Uncertainty about the outcome of the ruling ANC's leadership battles between its elective conference in December 2022 and the scheduled national general



election in 2024 could lead to market instability from time to time.

Should SA be greylisted by the global Financial Action Task Force in 2023, there could be short-term negative sentiment in markets, but we argue that a compendium of negative SA-specific factors (including a potential

greylisting) has already been incorporated by local and global investors into elevated risk premia for SA asset classes, as reflected in cheap valuations, and thus should not have a lasting negative impact on asset classes.

The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at [momentum.co.za](https://momentum.co.za). Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.

