PATHSTONE

Tactical Allocation Viewpoints

February 2023

After a historically difficult 2022, markets rebounded at the start of 2023 on building optimism that the Fed can navigate a “soft landing” for the economy. In this quarterly piece, Pathstone’s Managing Director of Strategy, John Workman, reflects on the macroeconomic picture and what that means for bottom-up portfolio construction heading into 2023.

The Macro Picture

Much of investors’ focus in 2022 was on inflation and interest rates, which pressured price-to-earnings multiples and drove bond yields higher. We believe the focus in 2023 is going to shift towards economic growth and corporate profits. As we move past the pandemic-induced spike in savings followed by a spike in spending, investors must try to gauge what “normal” should look like.

In the U.S., we anticipate that the Fed is not quite done with its interest rate hikes and expect they will maintain rates of 5% or more for most, if not all, of 2023. Higher interest rates are likely to weigh on consumer demand and therefore economic growth in addition to pushing borrowing costs higher, another factor that is likely to squeeze corporate profit margins. The question remains how resilient corporate and consumer spending will be and how investors will react before rates can be reduced towards long-term neutral (Fed Funds rate of 2.5%). In the background, concerns are starting to bubble up around the debt ceiling debate in Congress and whether that can be resolved without further disruption. The U.S. economy does risk a recession in 2023, but households and corporations have reasonably strong balance sheets, which may prevent a more severe outcome.

Europe continues to battle some of the highest rates of inflation globally but has gotten some reprieve as energy prices have come down significantly against the backdrop of a warmer winter. While consensus is still that Europe’s economy is at greater risk of recession than the U.S., equity prices seem to already discount that risk. Several factors bode well for Europe, including a relatively cheap Euro and the reopening of China, their most significant trade partner. These lower expectations matched with lower valuations make overseas markets more attractive relative to U.S. after a long period where U.S. equity markets outperformed Developed non-U.S. (11 out of the past 15 calendar years, including four out of the last five years). Interest rates are less onerous in Europe, though expected to rise. Significant fiscal stimulus to invest in sustainable energy and defense should provide a shot in the arm to growth.

Emerging Markets outlooks are diverse, but China remains the largest market and its economic impacts are felt well beyond its borders. China has recently flipped the script on many of its restrictive policies related to Covid protocols, real estate markets, and technology company scrutiny. The expected recovery in China may well have the most powerful economic impact globally in 2023. While tensions related to Taiwan’s independence remain a concern, the surrounding region should benefit from the Chinese reopening. Southeast Asia and India continue to offer growth potential, as does Mexico and perhaps some other regions that could benefit from adjustments to supply chains. A weaker U.S. dollar would benefit U.S.-based investors’ overseas returns.

Our Market Cycle Dashboard remains in negative territory for the seventh consecutive month and showed further deterioration in this month’s reading. Four of five categories now have Bearish readings with only Credit factors holding onto a neutral rating. Many factors point to a higher likelihood of recession. Investor sentiment, as measured by VIX and high-yield spreads, and the employment picture are the few remaining positives.

The Micro (Bottom-up) Picture

While quantitative tightening and higher interest rates elevate the risk of a recession, the strength of the labor market and recent declines in inflation provide support for continued economic expansion. We have taken several important steps in recent years to reduce risk exposure in portfolios and tilt towards assets that we believe are best positioned from a risk/reward standpoint considering the various potential scenarios. This quarter we are recommending clients that have an allocation to hedge funds trim the currently overweight position in equity risk-oriented hedge fund strategies, recognizing the potentially three-to-six-month lead time for redemptions of limited partnerships. We are doing this to increase liquidity in portfolios as we believe the interest rate and inflationary environment will be close to or beyond their peaks by then. We are also taking the first step in unwinding the significant short-duration tilt we have had in portfolios by moving a portion of short-duration back to intermediate in core fixed income. We feel we are getting sufficiently close to the end of the hiking cycle, where downside to duration risk will be mitigated.

We maintain our recommendation to tilt both U.S. large cap and Developed Non-U.S. equities towards value versus growth. We also continue to recommend a significant amount in short-duration fixed income versus intermediate duration, which provides us liquidity for opportunities we anticipate may arise in 2023.

As we look ahead, the opportunities that stand out most, based on our forward-looking capital market assumptions, include Developed and Emerging Markets equities versus U.S. The switch from massive quantitative easing to quantitative tightening removes the significant tailwind that propelled U.S. equities to outperform in recent years. Also, as we see the evolution of the business cycle, we are mindful that early in the cycle small cap stocks can be quite attractive. Small cap valuations are more attractive than large caps today, but we await more opportune timing as it relates to the business cycle. Implementing such a tilt may come via a direct allocation to small cap or even an adjustment from a market-cap-weighted U.S. equity index approach to an equal-weighted approach.

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