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Marketing Material

The investment landscape in 2023

A peak in official rates should offset subdued growth and still-high inflation in 2023, to the benefit of quality bonds and emerging markets.

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01 Overview: caution with a side order of optimism

2023 will be a year when the investment environment slowly gets back to normality. Inflation will come down – even if not quite as fast as the market

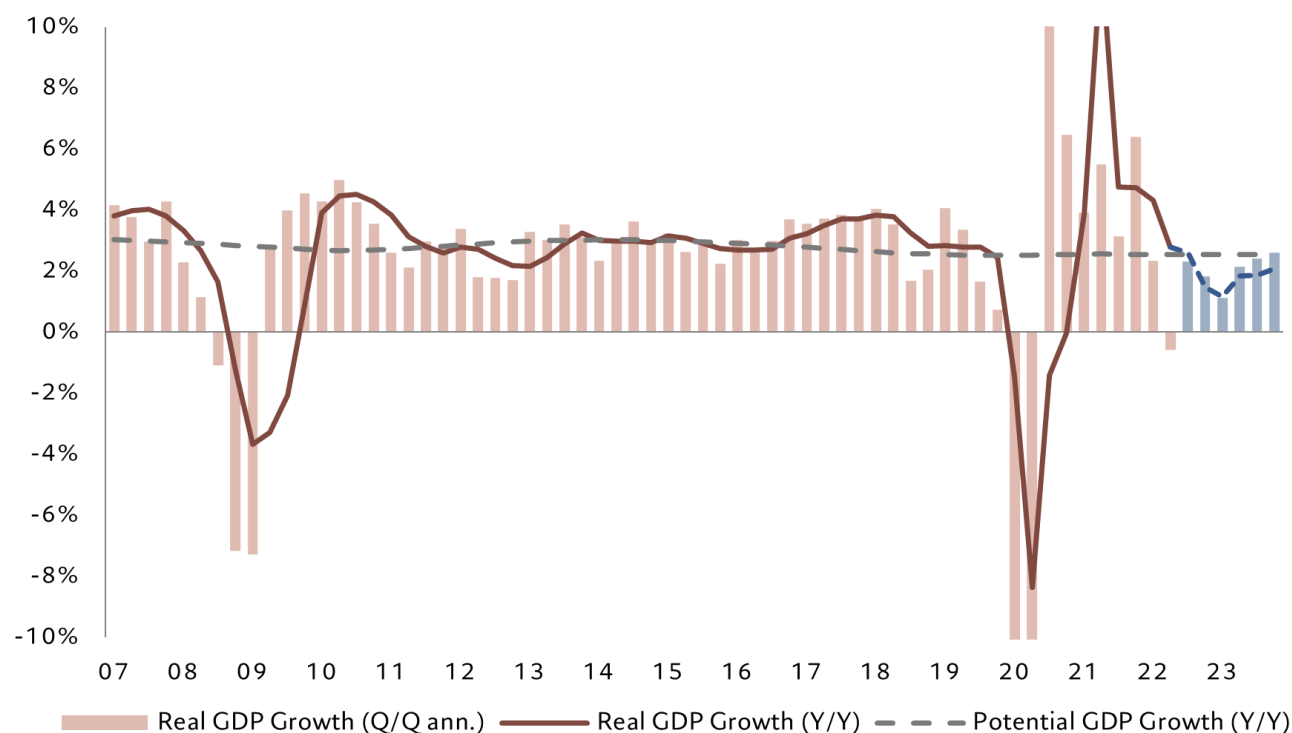
seems to expect. Economies will struggle for growth, but manage to stave off a deep downturn.

Equities are set to tread water, but fundamentals will suit high quality bonds. Meanwhile, emerging market assets, particularly local currency debt, are set to shine amid a weakening dollar and a revival in the Chinese economy.

The global slowdown – a number of indicators suggest various leading economies might already be in recession – has been the most anticipated one in living memory. Central banks have responded to this year's surge in inflation by putting on the brakes, and that's filtering through to their economies. As a result, global annualised quarterly real GDP growth is set to run at below potential through to at least the final three months of 2023 (see Fig. 1).

Figure 1 - Lacklustre

World real GDP growth, quarterly projections, %



*Blue bars are quarter on quarter annualised real GDP forecasts, blue broken line is year on year real GDP forecast. Source: CEIC, Refinitiv, Pictet Asset Management. Data from Q1 2007 to Q2 2022, forecast from Q3 2022 to Q4 2023.

But at the same time, the slowdown is likely to be less painful than past recessions. Corporate and household balance sheets are healthy, both still have excess savings built up during the Covid crisis, particularly in the US. This has allowed them to absorb some of the impact of inflation, while at the same time banks have continued to lend. Nominal growth, which is key to economies' resilience, has been running at some 10 per cent, largely on the back of very

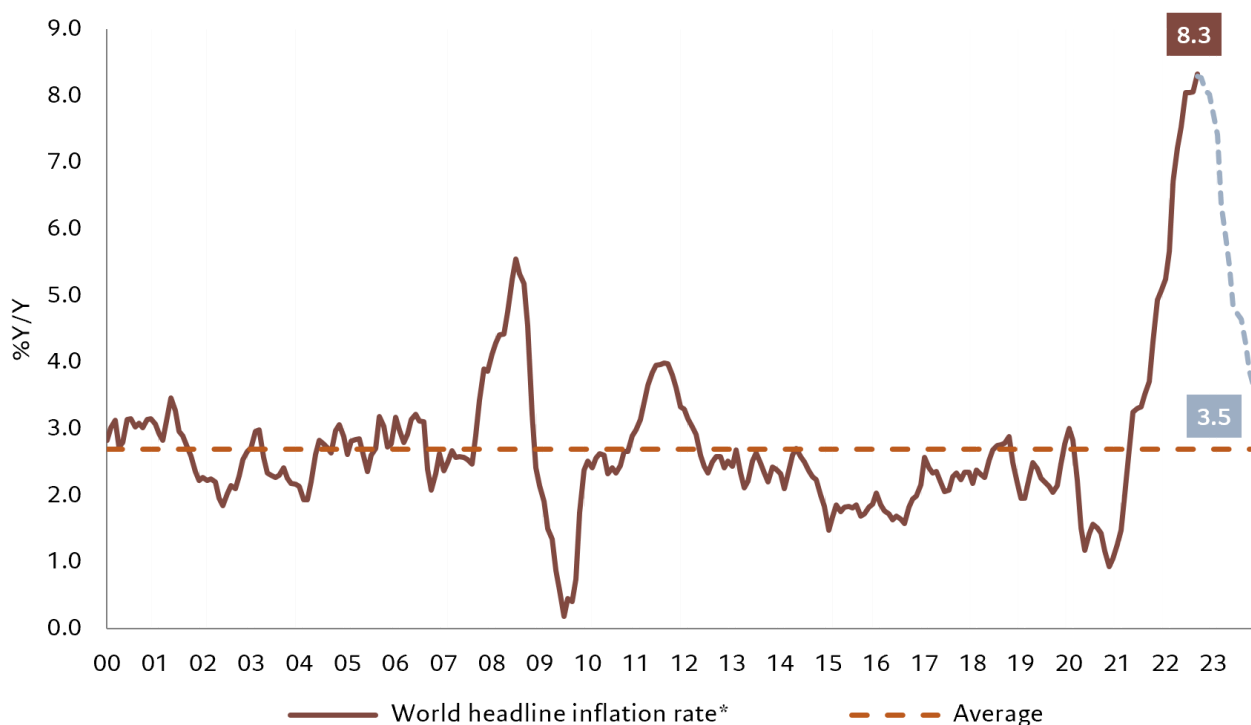
high inflation. So, unlike during the global financial crisis of 2008, this time there is no sign of a looming debt crisis in any of these economic segments.

An inflationary hurdle

Inflation will remain a hurdle, but it won't be the market's primary driver during the coming year (see Fig. 2). While there are signs it has already peaked in most major economies, we think investors are too optimistic about how fast inflation is likely to fall. The jobs market especially in the US remains strong, supporting wages. And components such as rents, which are a sizeable proportion of the consumption basket, are slow moving, taking longer to normalise.

Figure 2 - Down but not out

World monthly CPI inflation rate, year on year % change*



*GDP-weighted average of 40 countries' inflation rates. Forecast in light blue dashed line. Source: CEIC, Refinitiv, Pictet Asset Management. Data from 01.2000 to 09.2022; forecast from 10.2022 to 12.2023.

We also believe central banks will be cautious about entering into a new easing cycle – certainly, they won't make the switch anywhere near as quickly as the market expects. In part that's because central bankers are particularly sensitive to the risks of cutting rates before inflation has been fully suppressed. To do so would risk another, even less controllable surge in inflation, which would

shatter their credibility and force even more drastic efforts to get back to price stability. We don't think they will start to ease policy until 2024.

Direction of travel is key

What matters most for markets, however, is that official rates will have stopped rising. The end of monetary tightening will be greeted with relief, giving a lift to high quality debt – both sovereign bonds and investment grade credit. Shorter maturity debt is likely to benefit first, with bonds further along the yield curve showing more modest gains amid expectations of an economic revival. Investors should be more cautious about higher yielding debt, with the economic downturn is set to push up default rates.

And once rates peak, equities should start to benefit from improving valuation multiples offsetting weaker earnings – though that's more a story for the second half of the year.

With the US further along its tightening cycle than other major central banks, a peak in US rates is likely to put downward pressure on the dollar. The greenback is already considerably overvalued and its long-term fundamentals are poor – a currency's long-term value is determined by fiscal discipline and productivity growth and the US scores badly on both counts.

“What matters for most markets is that official rates will have stopped rising.”

A weakening dollar will be beneficial to emerging market assets, particularly emerging market local currency debt, which we see as a bright spot on the investment landscape, not just during the coming year but for some time to come. Further support for emerging market bonds and stocks is set to come from China's economic revival. We think that the government will have to respond to recent protest against its draconian zero-Covid policy by relaxing restrictions. At the same time, it has been offering some support to the country's vital but beleaguered real estate sector. Together, we think these effects will underpin growth of some 5 per cent over the coming year. Healthier Chinese growth will also benefit other emerging Asian economies.

In a nutshell, 2023 will be a year of caution for investors. But after a miserable 2022, when virtually all asset classes suffered drawdowns (with the notable exception of energy), there will also be reasons for cautious optimism.

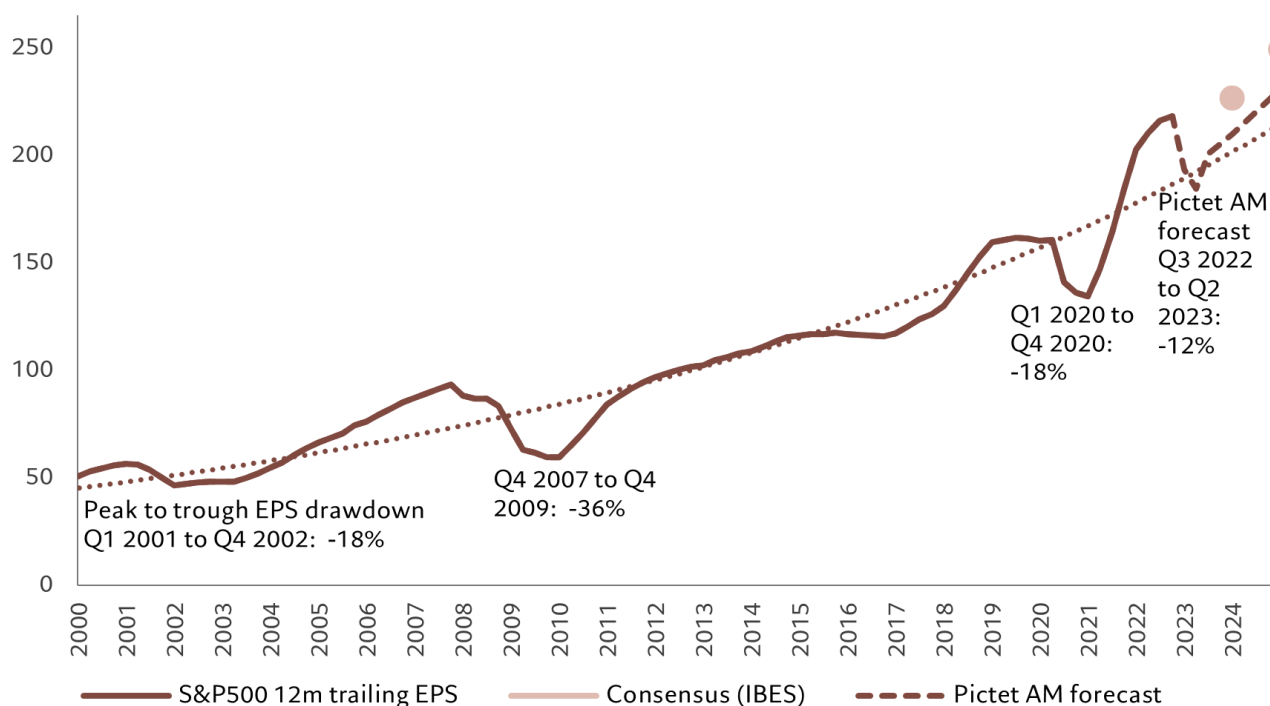
02 Equities: quest for growth

Next year is likely to be a relatively lacklustre one for global equities. But that would still be a major improvement on the dismal 2022.

One piece of good news is that corporate profits should hold up better than they have done during prior recessions. Companies have more pricing power and US consumers still have ample excess savings of around USD1.8 trillion. We expect S&P 500 earnings to decline by 12 percent from peak to trough, compared to falls of close to 20 per cent in both 2020 and 2001/2, and almost 40 per cent in 2007/9 (see Fig. 3).

Figure 3 - Relative resilience

US S&P 500 12-month trailing earnings per share



Source: Refinitiv Datastream, IBES, Pictet Asset Management. Data covering period 01.01.1998 – 30.09.2022, and forecasts through to 31.12.2024.

For all this, though, we expect earnings to fall short of analyst consensus expectations across much of the world. Our forecast is for global earnings per share to remain largely flat in 2023, versus consensus of around 3.4 per cent.

So for equities to deliver positive returns next year, investors will need to rely on an expansion of earnings multiples. Here, the signs are reasonably

encouraging.

Our analysis shows that historically there has been a strong correlation between excess liquidity (money supply less economic growth) and price-to-earnings (P/E) ratios. If, as we expect, monetary tightening comes to an end during 2023, we should see a modest expansion in P/E ratios of around 5 per cent globally. In the absence of earnings growth, it will come from higher prices as investors become willing to pay more for each unit of earnings. That, combined with modest dividends, should translate into returns of around 5-10 per cent for the MSCI All Country World Index.

The aggregate numbers mask a considerable divergence between countries and sectors, with investors likely to seek out areas with the best potential for growth.

China, EM and US to lead

Chinese stocks should outperform as the world's second largest economy emerges from Covid-related restrictions. It won't be an easy process, but we still believe that the direction is firmly towards reopening and the recent wave of protests could even accelerate that journey.

The opportunity is all the more compelling thanks to very attractive valuations, with China ranking as the second cheapest equity region in our model.

Emerging markets more broadly will be buoyed by weakening of the dollar (which, on our models is some 20-25 per cent overvalued versus developing world currencies) and a favourable shift in growth differentials, with EM growth accelerating from in-line with developed markets this year to 2.3 percentage points higher in 2023.

While most developed economies stagnate (or even shrink, in the case of the UK), growth in the developing counties is expected to pick up a little bit of pace. This, in turn, should translate into better corporate earnings – particularly for smaller companies which tend to have a stronger domestic focus.

Within the developed world, the US has the potential to outperform if, as we expect, Fed rate hikes come to an end and the country's economy remains resilient. Valuations are relatively expensive but less prohibitive than they have been: the price-to-12 month forward earnings ratio has moderated from a peak of 23.5 times in late 2020, and is now not far off its 10 year average of 17.5 times.

In contrast, we are cautious on the prospects for the euro zone. This is where we see the most significant drop in earnings (in excess of 6 per cent), with companies' bottom lines hit by an economic contraction and by a stronger euro exchange rate.

“ The US has the potential to outperform if, as we expect, Fed rate hikes come to an end and growth remains resilient. ”

The outlook for the UK is clouded by heightened inflation pressures and a struggling housing market, although the performance of the FTSE 100 should be cushioned by the high proportion of commodity producers and defensive sector stocks in the index.

More broadly, we remain cautious on sectors exposed to the economic cycle, such as industrials. Although cyclicals have underperformed defensives, we believe the gap has not been significant enough to reflect the likely further slowdown in the global economy.

Conversely, in a period of economic stagnation, investors will likely become more willing to pay a premium for companies whose own growth prospects remain strong, leading to an outperformance of the growth style over value. Healthcare, which combines growth with defensive characteristics, could thus do particularly well.

03 Fixed income and currencies: finding value in EM debt and Treasuries

Bonds are poised to deliver better risk-adjusted returns than equities over the next 12 months.

After an unprecedented sell-off in 2022, we expect positive bond returns of around 3 per cent globally on average. Stagnating growth and attractive valuation will be the main driver for the outperformance.

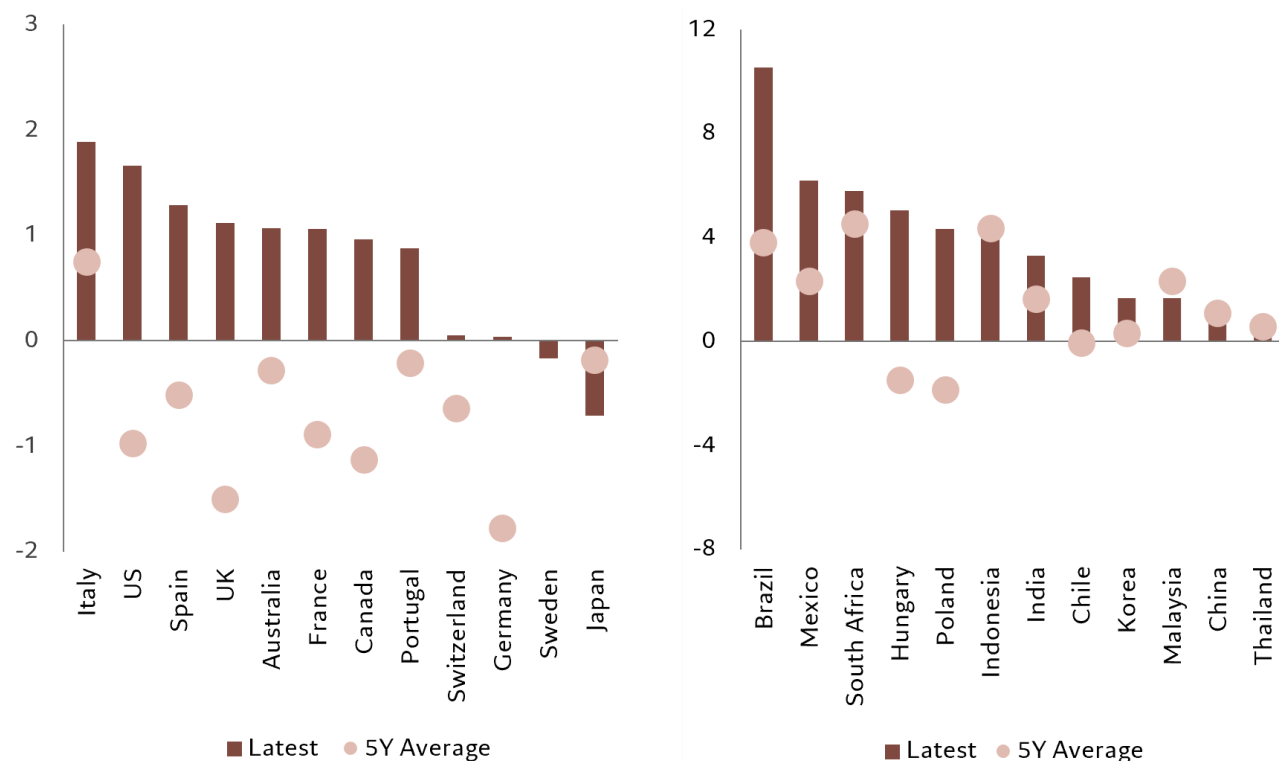
But investors need to be discerning as we expect a wide divergence in performance.

Perhaps the most promising part of the fixed income market is emerging market bonds.

One reason is valuation. More than 80 per cent emerging market bonds offer real yields that are higher than those in the US, with some markets such as Latin America offering real yields of over 10 per cent, well above their five-year average (see Fig. 4).

Figure 4 - Getting real

Real yields* in 10-year developed and developing market bonds



Source: Refinitiv, IMF, Pictet Asset Management, data as of 24.11.2022. * Real yields based on 10-year local currency government bond yield minus expected long-run inflation rate (using IMF forecasts for 2027).

Emerging market central banks have acted early and decisively to contain inflationary pressures, allowing them to better control inflation than their developed counterparts.

Their tightening cycle is more advanced than that of the Fed and other major central banks, and the cost of borrowing is unlikely to rise in the coming year.

Another positive for the asset class is the growing prospect for an appreciation of emerging market currencies against the dollar, which we expect will enter a structural decline next year.

Emerging market currencies are likely to be among the biggest beneficiaries from this decline as the developing nations' growth premium over their developed peers widens.

We expect growth in emerging economies to accelerate next year to 2.9 per cent from this year's 2.6 per cent, at a time when growth in most developed counterparts will slow or even contract.

This will help narrow the valuation gap between emerging currencies and the greenback by as much as 20 per cent, providing an additional source of return for investors in EM sovereign bonds denominated in local currencies.

We also like US Treasuries. The Fed is further advanced in the tightening cycle than its developed market peers and its rate rise campaign has almost run its course. We expect the US central bank to pause in the first quarter of 2023 with a terminal rate at 4.75 per cent.

We expect US 10-year yields will fall to 3.5 per cent by end-2023. An extra incentive for holding US Treasuries is an attractive valuation. At current levels, Treasury yields offer investors inexpensive protection from any further weakness in the global economy.

Compared with equities, investors will find more value in government bonds in the US, where the yield gap between the two asset classes is the smallest of all major economies.¹

“Investors should wait for clearer signs of an economic turnaround before allocating to the riskier part of developed corporate credit.”

In contrast, we are cautious on euro zone bonds. The region is unlikely to see bond yields fall, especially at the long end, as the European Central Bank will continue to play catch-up to rising price pressures.

The ECB is set to overtake the Fed in its tightening campaign, as it withdraws the Long Term Refinancing Operations (LTRO), its crisis-time cheap bank loan scheme. We expect the ECB to stop rate hikes in the second quarter of next year, at around 2.75 to 3 per cent. We forecast German bund yields to end the year little changed from today's level at around 2 per cent.

Corporate bonds warrant some caution too. Investors should wait for clearer signs of an economic turnaround before allocating to developed credit, especially in the riskier parts of the market. At a time when growth is likely to stagnate or contract, corporate earnings and margins are likely to fall,

impairing their ability to service debt. Against this backdrop, high-grade US corporate bonds offer relative value.

Default rates among high yield issuers are likely to rise further as debt financing costs increase.

In currencies, we expect the dollar to fall by 5 per cent against a basket of currencies, to around 100 as measured by the US dollar index.

A lack of fiscal discipline in the US and weak US productivity growth – it is currently at an all-time low of at -2 per cent – should herald the start of a secular decline for the dollar. Narrowing interest rate and growth differentials with the rest of the world should initially drive this move.

Along with emerging currencies, the Japanese yen will likely outperform the most versus the dollar. After hitting its weakest level in 37 years, our model shows the yen is undervalued by as much as 40 per cent against the greenback.

Elsewhere, gold represents the most attractive alternative asset for investors, supported by a weakening dollar and strong demand for the precious metal from China and India.

[1] 12-month forward earnings yield minus 10Y government bond yield, source: Refinitiv, IBES, Pictet Asset Management, data as of 24.11.2022

04 Updated tactical investment stance

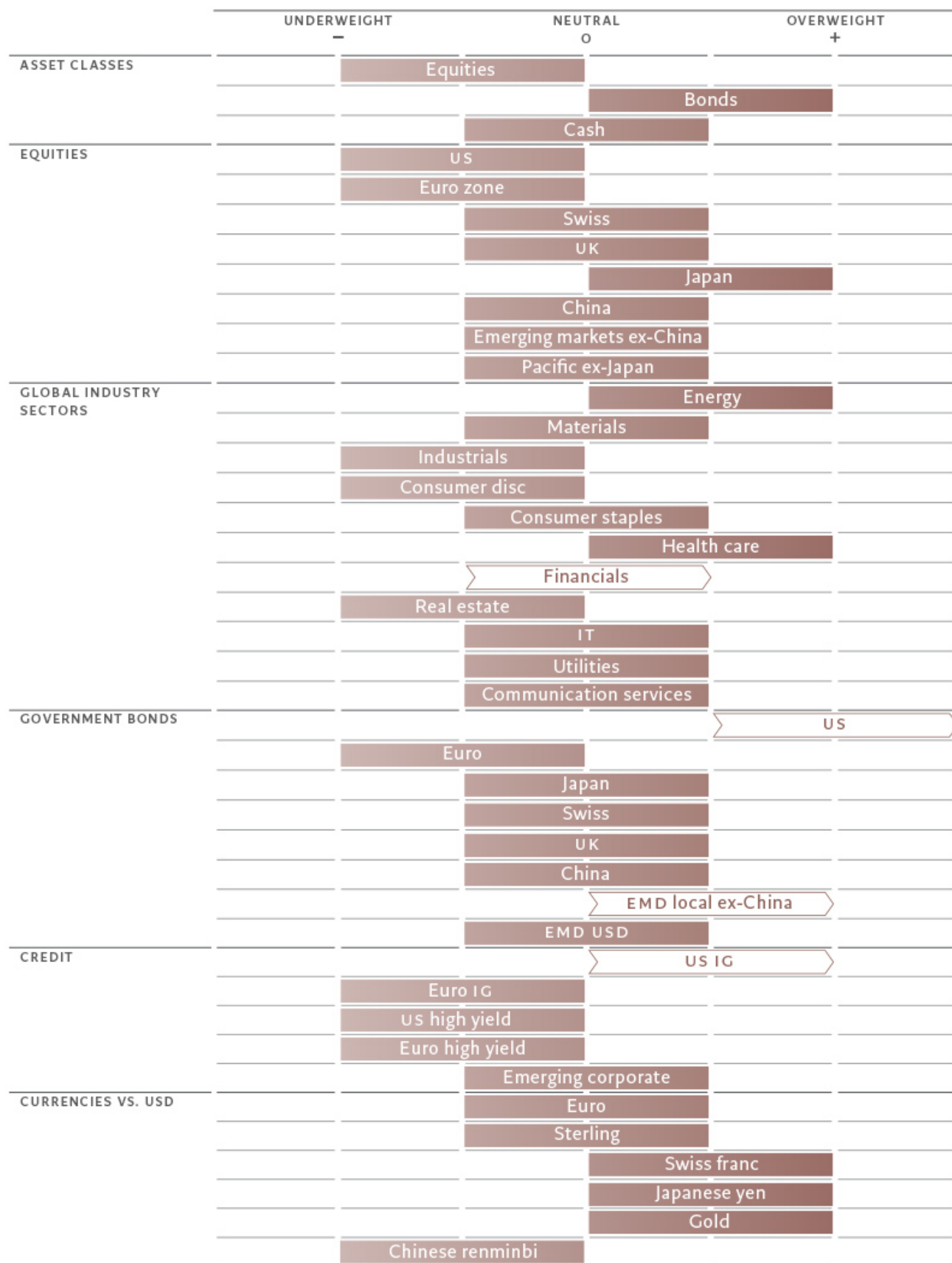
Our outlook for the year follows on from our monthly tactical asset allocation review where we made some changes to our investment grid, outlined below.

With inflation dynamics turning increasingly benign, the outlook for bonds is improving – fixed income investors can slowly emerge from their tortoise shells. The US is arguably furthest along the tightening cycle, which leads us to upgrade US Treasury bonds to our maximum overweight and US investment grade bonds to single overweight from neutral. In the latter case, the less risky end of the credit market offers attractive value and yields are high relative to default risks. In our view corporations are not over leveraged and any earnings downturn is likely to be mild. Hence we see scope for credit spreads to remain contained relative to previous business cycles.

As the peak of the global tightening cycle draws closer, emerging market bonds look set to become the biggest beneficiaries. We upgrade emerging market local currency debt to overweight from neutral. These bonds should benefit

particularly from a peak in the dollar, which has been propelled to multi-decade highs by the Fed's aggressive approach to combatting inflation.

Figure 5 - Monthly asset allocation grid
December 2022



Source: Pictet Asset Management

Elsewhere, we expect a rebound related to our central scenario for China. We are thus positive on Asian emerging markets given the typical spill-over into the region. There are also domestic factors supporting the region, not to mention the recovery in tourism. We also think that the emerging world will be more resilient this cycle compared to history. For the first time in decades, EM has been first to hike rates in the cycle. Having absorbed the rates shock thanks to robust growth, these economies stand to benefit as the tide turns, led by the Fed pausing the tightening cycle.

Meanwhile, rising rates have boosted banks' net interest margins. And as the economic outlook becomes less worrying – conditions are looking less at risk of stagflation and more along the lines of a traditional modest slowdown in growth – financials can benefit from higher profits for longer, which is why we upgrade the sector to neutral from underweight.

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