Riding the volatility in a changing world: House View 2023 Outlook Q&A

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With the release of Aviva Investors' House View 2023 Outlook, Jennie Byun (JB) puts the questions to Michael Grady (MG) on our latest economic and asset allocation views.

JB: What a year it has been. As you described it, it was one of rapid regime change – with inflation not as transitory as initially thought, Russia's invasion of Ukraine resulting in an energy shock and the fiscal response that forced inflation higher and pushed growth lower. What can we expect in 2023?

MG: We expect the energy supply shock and rapid tightening in monetary policy will push major economies into recession. The United Kingdom and euro zone are expected to be at the forefront, with both expected to see a decline in output in the final quarter of 2022 and further declines in 2023. The United States is expected to slip into recession in the second half of 2023. However, the recession is expected to be relatively mild given that household and corporate balance sheets are not extended.

Overall, global growth is expected to slow to around 2.5 per cent in 2023 and 2024, down from 3.25 per cent in 2022. Developed market economies are expected to account for all of that slowdown, with growth of just 0.5 per cent expected next year and one per cent in 2024, down from 2.25 per cent in 2022. That largely reflects the impact of the energy shock in the UK and euro zone, dragging down real disposable income and spending, alongside restrictive monetary policy weighing on households and businesses.

In emerging markets, growth is expected to be a little better, rising by around 4.25 per cent next year. This is mainly due to an improvement in China as it exits from its zero-COVID policies.

JB: What about inflation?

MG: Headline inflation is expected to decline in 2023, as the impact of earlier increases in energy and food prices falls out of the comparison with a year ago. That should account for a fall in headline inflation of between three and five per cent in the UK and euro zone and two and three per cent in the US. However, that view is conditional on an assumption oil and gas prices broadly follow the path shown by futures markets. There remains upside risk to that outlook.

Core inflation, which has been in the range of five to six per cent during the second half of 2022 in the US, UK and euro zone, should also decline in 2023. However, we expect that process will be quite slow, with core inflation likely to remain above central bank targets of two per cent. The risks are also to the upside here, but the range of possible outcomes is wide. Uncertainty about inflation is likely at its highest level in 40 years, with some of the largest forecast errors ever in 2022 from official bodies.

JB: Uncertainty is not making the jobs of central bankers any easier. Where do we see monetary policy moving from here?

MG: We expect central banks to continue to adopt a cautious approach to setting policy rates, with the primary focus to bring inflation down to target over a timeframe that doesn't create too much economic pain.

In our central projection, we expect the Federal Reserve, European Central Bank and Bank of England to reach the peak of the tightening cycle by the end of Q2 next year, with rates of around five per cent, three per cent and four per cent respectively.

Elsewhere, the Bank of Japan is likely to adjust its policy of yield-curve control in Q2, as a multi-decade inflation high feeds into moderately higher wage growth and higher inflation expectations. We expect the People's Bank of China will continue to run easier policy through 2023 to help encourage the post-COVID recovery.

JB: Moving to markets, what are your thoughts on the changing dynamics we have experienced over the past year?

MG: Underlying fragilities are often exposed during economic downturns and, depending on feedback loops and spill overs, can lead to damaging market implosions and sometimes more severe depressions.

This is no longer a risk but a reality, as highlighted by the serial defaults and insolvencies of Chinese real estate developers, the British liability-driven investment conflagration and the FTX bankruptcy.

There will almost certainly be more to come. The hope that the coming recessions and slowdowns will be "mild" rests in large part on markets adjusting to a new and harsher reality without too much disruption.

An important change in 2022 was the positive correlation between government bond and equity returns. That resulted from a sharp and largely unexpected reversal of the ultra-accommodative monetary policy of the past 12 years. Looking ahead, we expect more frequent supply shocks, potentially resulting in more persistent inflation. This will likely result in less reliable equity and bond dynamics than in the past 20 years.

JB: How can investors navigate this new regime?

MG: Bond allocations will need to be reviewed but are not the only asset class under scrutiny. Given how much bonds have sold off in 2022, yields are now at levels where one of the fundamental reasons for holding them, to dampen investment portfolio volatility, is likely to hold; however, the returns and level of diversification will likely not match the past.

With negative yields in the past, cash is no longer a drag on portfolios and thus TARA (there are real alternatives) to risky assets is the appropriate viewpoint. In this context, real yields, corporate bond spreads and equity risk premia are all likely to be structurally higher going forward – making some of the spread-widening and equity de-rating permanent. This could encourage investors to shift allocations back towards less risky assets while still generating the same or better returns.

Given the breakdown in established relationships and overall uncertainty, investors may need to embrace alternative sources of diversification. Using a diversified set of strategies, investors can aim to improve risk-adjusted returns. Direct exposure can be achieved via inflation, interest rates and yield curve positioning, with indirect exposure achieved through commodities, currencies, and specific equity sectors.

For instance, physical assets, such as oil, should move with inflation, which will benefit commodity producing countries and companies. Many measures, such as repo markets, bid-ask spreads, dislocations on curves, are showing meaningful stress. That indicates opportunities for relative-value trades in mispriced or less liquid assets.

JB: Could you summarise our asset allocation views?

MG: We are broadly neutral on equities. Equity markets have de-rated through 2022, reflecting higher real rates. While markets have seen a significant rally into year end, it is premature to be pricing a recovery in the economic cycle.

Looking to 2023, we expect downward revisions to earnings expectations, reflecting the shallow economic recession, to weigh on markets. Only once there is a clear downshift in inflation do we expect risk assets to perform better. We have a mild preference for the UK over Europe given the relative exposure to energy and natural resources.

Within government bonds, we are modestly underweight duration, with upside inflation risks outweighing recession risks. However, the peak in policy rates is likely approaching, requiring a nimbler approach to duration in 2023.

We prefer to be neutral on credit, where we think the recent rally in spreads makes high yield less attractive going into a recession. On investment grade, the all-in yield on short-dated paper makes it relatively appealing but it is competing with attractive risk-free cash returns. Within emerging market debt, country selection remains vital as economic and political risks vary.

For commodities, the cyclical downturn has eased industrial metals, but tight supply means energy prices will remain supported, with $80-100 oil needed to spur production and lower demand. Natural gas remains constrained by Russia, and this keeps a floor on coal and crude, while also feeding through to other downstream commodities and goods. There is also the risk that China's re-opening puts renewed upward pressure on commodity prices.

Finally, we prefer to be long the US dollar going into 2023, reflecting the weakening global growth environment and the strength of underlying inflation in US. However, longer-term dollar move higher could reverse as growth prospects improve in the second half of next year.

JB: What impact could the elevated oil price have on the energy transition?

MG: Risks around energy and resource scarcity will underpin much of the energy transition this decade as the urgency of decarbonising the global industrialised economy is set against a backdrop of a dwindling carbon budget and pool of high-density energy sources. This requires an ability to think both 'fast and slow' and a two-pronged approach: firstly, increasing net energy availability, and secondly, reducing energy consumption and doubling down on existing low-carbon options.

The conclusions of this year's COP27 in part reflect unease at phasing out or cutting down the use of fossil fuels and highlights the so-called 'oil paradox' that sits at the core of the energy transition; the recognition that oil is essential to the globalised economy and yet – along with habitat destruction and loss of biodiversity – is one of its biggest risk drivers in endangering planetary life support systems.

The current energy predicament further underscores the challenge in finding scalable alternatives with respect to hard-to-abate sectors and the need for triaging energy sources or managed planning of the transition.