



2023  
Global Market  
**Outlook**  
The Need for Agility





# 2023 Global Market Outlook



## An Economic Balancing Act

Central bank efforts to bring inflation under control have reached a critical point. In 2023, investors will be looking for the peak in interest rates.

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## Leaning Against the Wind

U.S. earnings growth estimates may be too optimistic. But we see relative valuation advantages in some equity sectors and in non-U.S. markets.

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## The Return of Yield

The worst bond bear market on record pushed yields to some of the most attractive levels since the global financial crisis. Investors appear to have noticed.

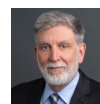
**page 6**



## Deglobalization in a Connected World

The threat of global economic decoupling has been exaggerated, but big structural changes are in progress. We see opportunities amid the disruptions.

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**Andrew McCormick**

*Head of Global Fixed Income  
and Chief Investment Officer*



**Sébastien Page, CFA**

*Head of Global Multi-Asset  
and Chief Investment Officer*



**Justin Thomson**

*Head of International Equity  
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## Tactical Allocation Views

Our views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.

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## INTRODUCTION

# A Time to Be Selectively Contrarian

“Active management skill is just incredibly important in this environment.”

— Sébastien Page  
Head of Global Multi-Asset  
and Chief Investment Officer

Heading into 2023, capital markets appear to have priced in a significant global economic slowdown. The key question is whether this deceleration will end in a “soft landing”—with slower but still positive growth—or in a full-fledged recession that drags down earnings.

Much depends on the U.S. Federal Reserve (Fed) and the world’s other major central banks as they continue efforts to bring inflation under control by hiking interest rates and draining liquidity from the markets.

“History is not on our side,” says Sébastien Page, head of Global Multi-Asset and chief investment officer (CIO). “Fed hiking cycles don’t generally end well, especially when inflation is running high.”

But investors shouldn’t assume a deep downturn is inevitable, Page adds. Although some leading indicators have weakened (Figure 1), U.S. employment was still growing in late 2022. Corporate and household balance sheets appeared strong. And the economic wounds inflicted by the COVID pandemic continued to heal, notes Justin Thomson, head of International Equity and CIO.

Geopolitical risks will remain potential triggers for downside volatility in 2023. Structural factors, such as bank

capital requirements that constrain market liquidity, could magnify price movements, both up and down.

With most central banks seeking tighter financial conditions, investors can’t count on them to intervene if markets fall, warns Andrew McCormick, head of Global Fixed Income and CIO.

“We’ve come out of a period where central banks had strong motivation to suppress volatility,” McCormick says. “Now, policy is aimed at tightening financial conditions. So there is no buyer of last resort when markets come unhinged.”

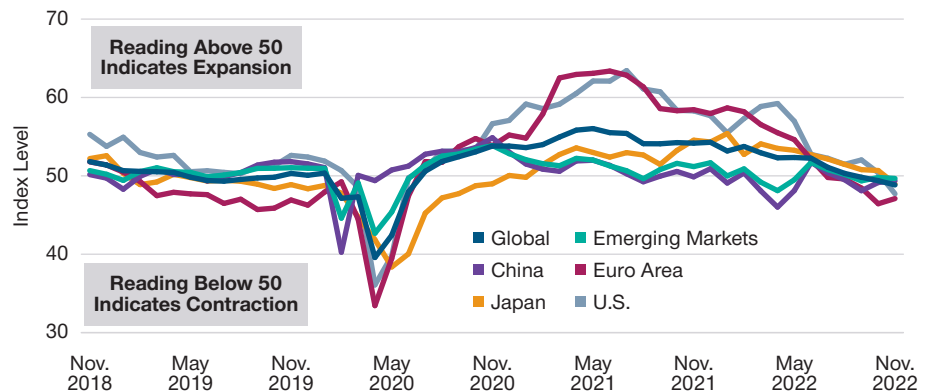
But excessive pessimism and volatility can create value for agile investors, the CIOs note. An attractive point to raise tactical exposure to equities and other risk assets may appear in 2023, Page predicts. However, as of late 2022, it had not yet arrived, in his view.

Until it does, Page favors a “selectively contrarian” approach of tilting toward specific sectors within asset classes—such as small-cap stocks relative to large-caps and high yield relative to investment-grade (IG) bonds.

In difficult markets, security selection will be critical, Page says. “Active management skill is just incredibly important in this environment.”

## Leading Indicators of Economic Growth Are Fading

(Fig. 1) Purchasing Managers’ Index Levels for Manufacturing



As of November 2022.

Sources: Institute for Supply Management/Haver Analytics, J.P. Morgan/IHS Markit, Bloomberg Financial L.P. (see Additional Disclosures). Data analysis by T. Rowe Price.

**THEME ONE**

# An Economic Balancing Act

The outlook for inflation and interest rates (Figure 2) will remain critical in 2023 as investors try to estimate where rates will peak and when the Fed might “pivot” toward monetary easing.

U.S. consumer inflation slowed in late 2022, thanks to a partial unwinding of the oil and other commodity price spikes seen earlier in the year. But inflation in the services sectors remained “sticky” as tight labor markets continued to push wage costs up at a relatively rapid clip.

“In the U.S., inflation has likely peaked,” Thomson predicts. “But the key question is where it lands. And I think it’s unlikely to be at the Fed’s presumed target of 2%. We know that inflationary shocks like this one can take years, not months, to work through.”

Sticky inflation creates considerable uncertainty about where interest rates will peak in this Fed tightening cycle.

With rates now in “restrictive” territory, McCormick says, Fed policymakers may slow the pace of hikes. But futures markets suggest investors still expect the Fed to lift the target for its key policy tool, the federal funds rate, to around 5%.

Fed policymakers hope to be able to pause at some point to allow the impact previous rate hikes to work their way through the economy, McCormick adds. Whether a pause turns into a pivot or is followed by additional hikes, he says, will depend on the balance between inflation and recession risks. But a quick turn to easing in 2023 appears unlikely.

This means investors waiting for a clear sign that Fed policymakers are ready to cut rates could be left standing on the sidelines longer than they currently expect. “A lot of investors are looking for a Fed pivot,” Page says. “But I think it’s unlikely as long as U.S. employment numbers remain strong.”

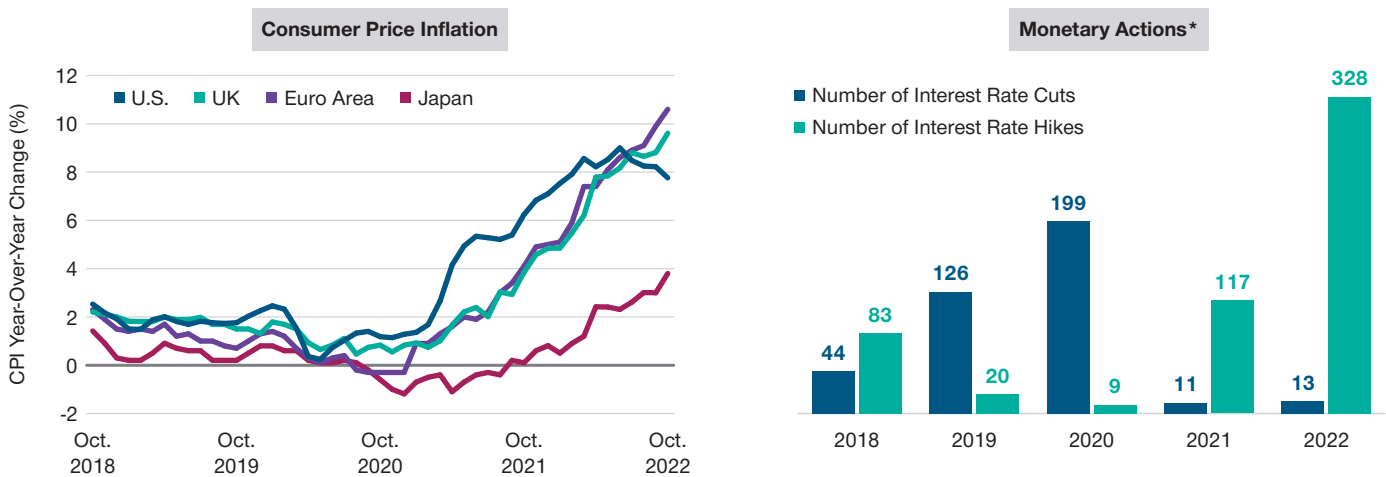
### A Mixed Monetary Picture

The inflation picture is more mixed in other major developed markets, as is the expected path of monetary policy.

- In Europe, high energy prices mean that inflation is likely to be more stubborn than in the U.S., Thomson says. This leaves the European Central Bank (ECB) in a difficult spot, McCormick adds. “Higher inflationary pressures

## Central Banks Are Struggling to Control Inflation Without Pushing the Global Economy Into Recession

(Fig. 2) Year-Over-Year Change in Consumer Price Inflation and Global Monetary Policy Actions



CPI as of October 31, 2022. Monetary actions as of November 30, 2022.

\*Number of interest rate cuts and interest rate hikes made by all central banks globally.

Sources: Bloomberg Finance L.P. and Bloomberg Index Services Limited, CBRates.com (see Additional Disclosures).

“Over the longer term, a number of structural factors are likely to tilt the U.S. and the other major developed economies toward higher inflation.

— Justin Thomson  
 Head of International Equity  
 and Chief Investment Officer

coupled with a high risk of recession will be quite a test for the ECB.”

- Japanese policymakers may welcome higher consumer inflation in hopes that it will bleed through into wage growth, Thomson says. The Bank of Japan shows no signs of abandoning its version of quantitative easing, which involves managing the yield curve for Japanese government bonds.

Over the longer term, Thomson argues, a number of structural factors are likely to tilt the U.S. and other major developed economies toward higher inflation. These include:

- Slow or negative population growth in many developed countries, aggravated by lower workforce participation rates.
- A “reshoring” of global supply chains, which could make production less efficient.
- Demand pressure from heavy capital spending on the transition to sustainable energy sources.
- A greater appetite for deficit-financed spending on the part of many developed market governments.

### U.S. Dollar Strength Could Be Challenged

Fed rate hikes contributed to a surge in the value of the U.S. dollar (USD) in 2022, Thomson notes, creating tight conditions for non-U.S. borrowers, both public and private, who rely on USD funding. Less clear, he says, is whether this trend will continue in 2023.

“The dollar has always traded as a risk-off asset,” Thomson observes. “What was unusual this time around was its persistent strength against other major developed market currencies.”

Despite weakening somewhat in the last quarter of 2022, as of late November the USD remained between 35% and 50% overvalued against the euro, the yen, and the British pound on a purchasing power parity basis, Thomson estimates.

Exchange rates can defy fundamentals for lengthy periods, Thomson notes. But, given the level of USD overvaluation, economic surprises—such as a sooner-than-expected Fed pivot—easily could push the U.S. currency lower in 2023. “We should expect a weaker dollar and think about what that would mean for portfolio construction,” he says.

## AN ECONOMIC BALANCING ACT

| Investment Idea                        | Rationale  | Examples   |
|--|--|--|
| A Slowing Economy Favors Long Duration | The Fed hiking cycle isn’t complete, but it has covered much ground. Long duration Treasuries historically have performed well in recessions and could provide diversification as the economy weakens.                             | <ul style="list-style-type: none"> <li>Long-Term U.S. Treasuries</li> </ul>                  |
| Playing Selective Offense              | Small-caps have priced in a dire economic scenario and may offer upside when inflation and growth outlooks improve. Yields on high yield bonds are attractive relative to recent history and are supported by strong fundamentals. | <ul style="list-style-type: none"> <li>Small-Cap Stocks</li> <li>High Yield Bonds</li> </ul> |

For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action.

**THEME TWO**

**Leaning Against the Wind**

Soaring bond yields largely drove equity bear markets in 2022 by compressing valuation multiples. But in 2023, earnings growth could move to the top of the list of investor concerns.

As of the end of November, forward consensus estimates predicted mid-single-digit growth in earnings per share (EPS) for the U.S. and Japan over the following 12 months, and even slower EPS growth in Europe and the emerging markets (Figure 3, right).

Those estimates appear overly optimistic, Page cautions. Past U.S. recessions typically have resulted in 15% to 20% earnings declines for the S&P 500 Index, he notes.

Thomson lays out three possible U.S. earnings scenarios, the first reflecting a soft landing, the second a “normal” recession, and the third a recession plus a reversal in a 25-year trend toward higher U.S. profit margins.

- In a soft-landing scenario, recent EPS assumptions for the S&P 500 Index appear reasonable.
- A “normal” recession, based on the last four U.S. recessions (not including the 2008–2009 global financial crisis),

could see EPS decline by 19% over the next 18 months.

- A recession with shrinking profit margins could produce EPS losses somewhat worse than in a “normal” recession.

Although U.S. equity valuations declined sharply in 2022, the price/earnings ratio (P/E) for the S&P 500 remained relatively high historically as of the end of November, Page notes (Figure 3, left). Excess liquidity and demand from passive investors could be propping up the index’s P/E, Page suggests, leaving it vulnerable to further compression if earnings disappoint.

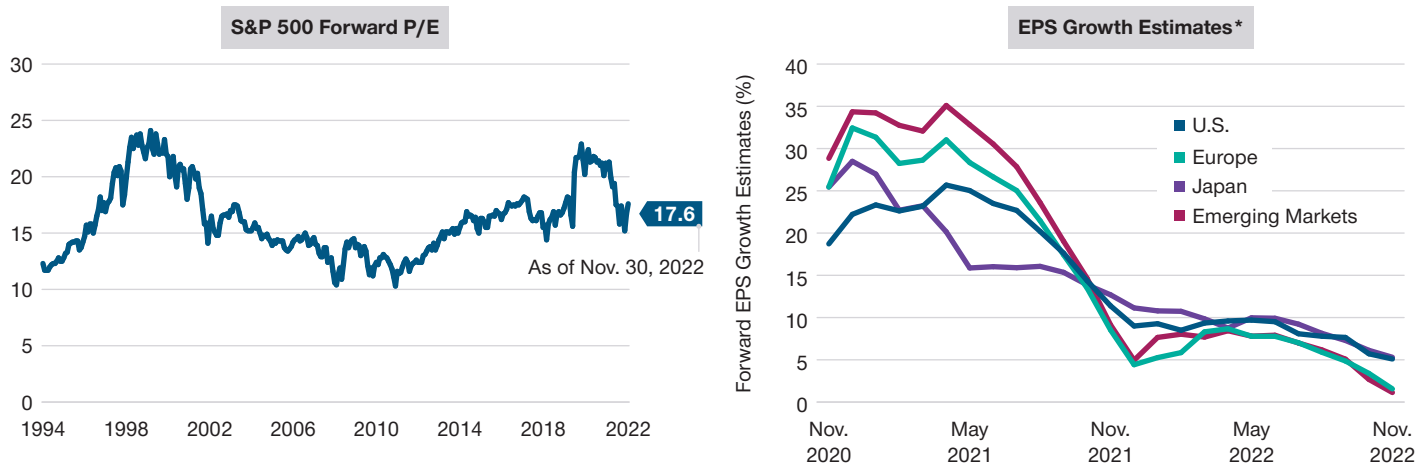
**Regime Change Brings New Leadership**

Thomson notes that growth fears in 2022 boosted the popularity of stocks with relatively low historical exposure to market volatility and of “durable growers”—companies with track records of delivering relatively stable revenue and earnings growth. Both groups now appear overvalued, he says.

The trend toward higher inflation and interest rates, Thomson contends, marks a “regime change,” a structural shift with major implications for relative performance.

**Equity Valuations Are Cheaper, but Earnings Growth Estimates Have Decelerated**

(Fig. 3) 12-Month Forward P/E on the S&P 500 Index and One-Year Forward EPS Growth Estimates



As of November 30, 2022.

\*U.S. = S&P 500 Index, Europe = MSCI Europe Index, Japan = MSCI Japan Index, Emerging Markets = MSCI Emerging Markets Index.

Sources: Standard & Poor’s, MSCI (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

“We know from history that regime changes nearly always are associated with changes in market leadership.

— Justin Thomson  
 Head of International Equity  
 and Chief Investment Officer

“We know from history that regime changes nearly always are associated with changes in market leadership,” he says.

The value style should be a long-term beneficiary of this rotation, Thomson predicts. “I think we’re probably still in the early innings of this value cycle.”

As a group, value stocks historically have outperformed growth stocks in high-inflation periods, Page notes. One reason: Higher inflation tends to push up interest rates, fattening lending margins for banks, which carry a heavy weight in the value universe.

Value also appears historically inexpensive relative to growth, Page adds, even though U.S. value benchmarks significantly outperformed their growth counterparts in 2022.

U.S. small-cap stocks also could offer relative performance advantages if the U.S. economy doesn’t fall into deep recession in 2023. On average, small-cap earnings have recovered more quickly than large-cap earnings in past economic recoveries, Page points out. U.S. small-cap valuations also appear cheap, both in historical terms and relative to large-caps, he adds.

Thomson, however, cautions against painting the small-cap universe with too broad a brush. “It’s a diverse asset class,” he notes. “The more cyclical parts should do well coming out of a

recession. But small growth is likely to do less well.”

### Tailwinds for Non-U.S. Markets

Regime change—the economic kind—also could boost the appeal of non-U.S. markets in 2023, Thomson argues.

- Value stocks, particularly banks, are less heavily weighted in the major U.S. indexes than in most non-U.S. markets. So high interest rates and value leadership should favor the latter.
- Sectors that historically have proven resilient to inflation, such as energy and materials, are better represented in many non-U.S. equity markets, especially emerging markets (EMs).
- The “de-rating” of the big technology platform companies has only begun, Thomson argues. Big tech is underrepresented in most non-U.S. equity markets, he notes.
- For USD-based investors, a reversal in dollar strength would put a tailwind behind local currency returns in non-U.S. markets.

Japan could be a less obvious beneficiary of these trends, Thomson says. If higher consumer inflation bleeds through into wage growth, it could shock the economy into a higher level of domestic demand, which would be good for Japanese equities.

## LEANING AGAINST THE WIND

| Investment Idea                      | Rationale   | Examples   |
|--------------------------------------|---|--|
| A Cautious View on Equities          | Equity valuations are more reasonable, but earnings expectations appear to be too optimistic. Time is needed to assess Fed progress on inflation and better understand the potential depth and duration of the economic slowdown.           | <ul style="list-style-type: none"> <li>Underweight Stocks</li> <li>Cash Buffer for Future Opportunities</li> </ul> |
| An Emphasis on Valuation and Quality | Stocks that do not fit neatly into growth or value buckets have been somewhat overlooked. Many companies in this middle category offer attractive growth potential at more reasonable valuations than can be found at either style extreme. | <ul style="list-style-type: none"> <li>Core Equity</li> <li>Higher-Quality Small-Caps</li> </ul>                   |

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## THEME THREE

# The Return of Yield

A brutal year for bond markets in 2022 ended with a silver lining for investors: It raised fixed income yields to some of the most attractive levels seen since the global financial crisis.

Higher yields (Figure 4, left) were mirrored in greatly improved valuations for both sovereigns and private credits, with many sectors selling close to or below their 15-year historical medians as of late November (Figure 4, right).

Higher-quality credits in the mortgage-backed and asset-backed sectors also are attracting inflows from investors looking to put cash to work or extend duration (a measure of interest rate sensitivity), McCormick adds.

“This is the first opportunity to lock in high-single-digit yields in well over a decade,” McCormick says. “Anytime there’s been a glimmer that the Fed might be ready to slow its pace, or that inflation might have peaked, we’ve seen money find its way into the market.”

High yield bonds could offer particularly attractive return opportunities in 2023,

McCormick and Page both say. Page cites three potential positives:

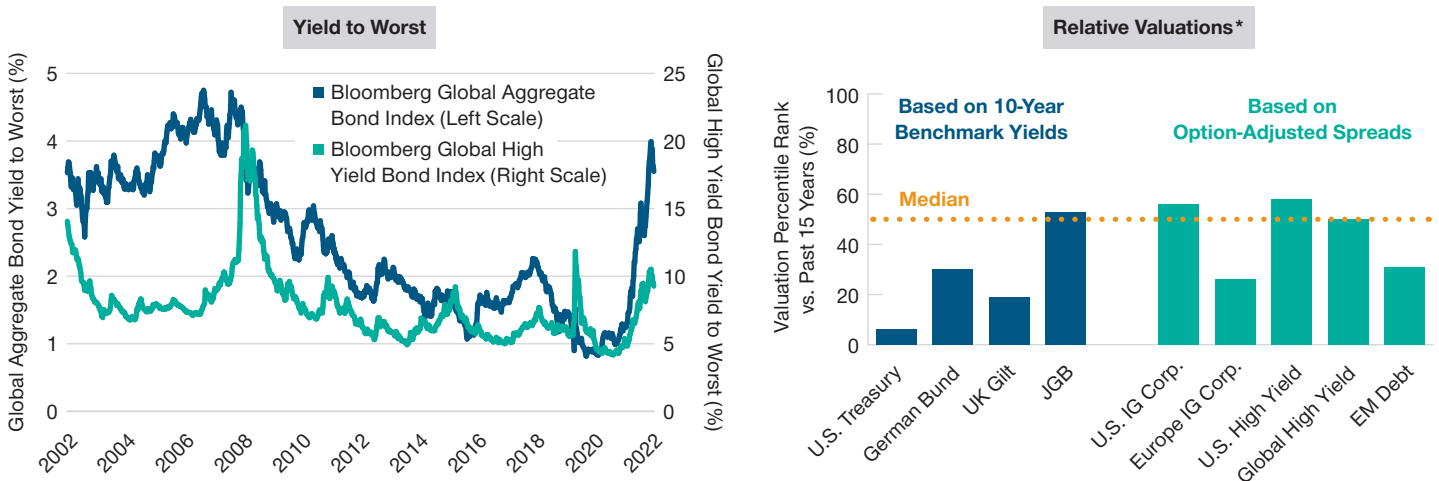
- Credit spreads—the yield difference between private credits and comparable U.S. Treasury maturities—have widened while default rates remain relatively low.
- Corporate balance sheets generally are in strong shape.
- The energy sector accounts for a smaller share of U.S. high yield debt than in the past, reducing default sensitivity.

Default rates almost certainly will rise if the U.S. economy slips into recession, Page acknowledges. But it would take a substantial leap to offset the return advantage built into current spreads. “If we get anything outside of a deep recession, the valuation case for U.S. high yield appears pretty strong,” he argues.

As of late November, McCormick adds, T. Rowe Price credit analysts estimated that U.S. default rates could rise to slightly under 3% for high yield bonds and just over 3% for floating rate bank loans in

## The Bond Bear Market Has Improved Both Yields and Relative Valuations

(Fig. 4) Yields on Aggregate Bond and High Yield Indexes; Fixed Income Valuations vs. Historical Averages



Yields as of November 25, 2022. Valuations as of November 30, 2022.

\*U.S. Treasury = 10-Year Note, German Bund = 10-Year Bund, UK = 10-Year Gilt, JGB = 10-Year Japanese Government Bond, U.S. IG Corp. = Bloomberg U.S. Investment Grade Corporate Index, Europe IG Corp. = Bloomberg EuroAggregate Credit Index, U.S. High Yield = Bloomberg U.S. Aggregate Credit-Corporate High Yield Index, Global High Yield = Bloomberg Global High Yield Index, Emerging Markets Debt = Bloomberg Emerging Markets USD Aggregate Index. Sources: Bloomberg Financial L.P. and Bloomberg Index Services Limited (see Additional Disclosures). T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.



“We’ve already seen bouts of illiquidity in some high-quality markets....We believe the risk of further episodes remains elevated.”

— Andrew McCormick  
Head of Global Fixed Income and  
Chief Investment Officer

2023, significantly less than current credit spreads. This forecast assumes that the U.S. economy passes through a mild recession, McCormick adds.

The outlook for European high yield is more guarded, McCormick cautions. While yields also have improved in those markets, the value proposition is less compelling because of the economic backdrop, he says.

### Illiquid Markets Could Be Volatile

Market liquidity deteriorated in 2022 as monetary tightening accelerated, McCormick notes. As central banks shrink their balance sheets in 2023, new buyers will be needed. But stricter capital rules put in place after the global financial crisis have made it harder for bond dealers to function as liquidity providers.

“We’ve already seen bouts of illiquidity in some high-quality markets, like UK gilts and U.S. Treasuries,” McCormick notes. “We believe the risk of further episodes remains elevated.”

But poor liquidity and price volatility also can create opportunities for longer-term investors, McCormick notes. The U.S. municipal bond market, for example, experienced several months of outflows in late 2022 as investors harvested tax losses and repositioned for higher rates.

Credit conditions in the muni market appear strong, McCormick says. State and city governments received federal support during the pandemic shutdown, he notes, and saw tax revenues rise when businesses reopened. Given these fundamentals, muni yields and spreads

remained attractive by most historical standards as of late November, which was attracting buyers back to the market.

### Diversification in an Inflationary World

Higher volatility also has big implications for portfolio construction, Page says. But the key issue is the source of that volatility and its impact on asset correlations.

Historically, Page says, returns on stocks and on U.S. Treasuries have tended to move in the same direction when worries about inflation and interest rates are high—as they were in 2022. This can destroy the diversification benefits of Treasuries. But, when concerns about economic growth are uppermost, returns can move in opposite directions, increasing the diversification benefits of Treasuries.

If 2023 is dominated by concerns about growth, Treasuries could resume their traditional role as portfolio diversifiers, Page predicts. But, over the longer run, he says, different tools may be needed. These could include:

- “Barbell” structures that divide bond allocations between long Treasuries and fixed income diversifiers such as high yield, floating rate, and EM debt.
- Alternative strategies that seek to deliver positive absolute returns.
- Real assets equities, such as energy, real estate, and metals and mining stocks.
- Equity strategies that potentially offer downside risk mitigation in inflationary environments when Treasuries fail.

## THE RETURN OF YIELD

| Investment Idea                 | Rationale   | Examples  |
|---------------------------------|---|---|
| Bond Yields Are More Attractive | Higher interest rates and wider credit spreads have lifted yields in many fixed income sectors. While a slowing economy could further widen spreads, current yield levels provide a buffer against a rise in default rates. | <ul style="list-style-type: none"> <li>■ High Yield Bonds</li> <li>■ Municipal Bonds</li> </ul> |

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## THEME FOUR

# Deglobalization in a Connected World

Geopolitical tensions and supply disruptions have led some analysts to question whether an era of economic integration has ended, dimming prospects for productivity and growth. But that risk appears to have been exaggerated, the CIOs say.

“Globalization isn’t dead. It may not even be dying,” Thomson argues. Economically, he notes, globalization has been defined by the fivefold rise in international trade as a percentage of world gross domestic product since the early 1950s. While that ratio has stopped rising, it also isn’t falling, he notes.

But recent events have shown that globalization is changing, Thomson adds. A number of economies have become dependent on critical imports from one specific part of the world, he says. Europe’s heavy reliance on Russia for natural gas, for example, put its energy security at risk when the war in Ukraine sent gas prices soaring.

Market forces can correct such imbalances if given time, Thomson says. This was demonstrated by the large declines seen in European gas prices in the second half of 2022 (Figure 5, left) as demand forecasts were slashed and new supply was rerouted to those markets.

Over the longer run, Thomson argues, energy development could drive a massive global surge in capital spending on the transition from fossil fuels to renewable energy sources. “The numbers that will be required are mind-boggling,” he says. “I’ve seen estimates as high as USD 100 trillion.”

Capital expenditures on that scale, Thomson predicts, should generate investment opportunities on an equally grand scale in the technology, materials, and capital goods sectors, as well as in alternative energy producers and efficiency innovators.

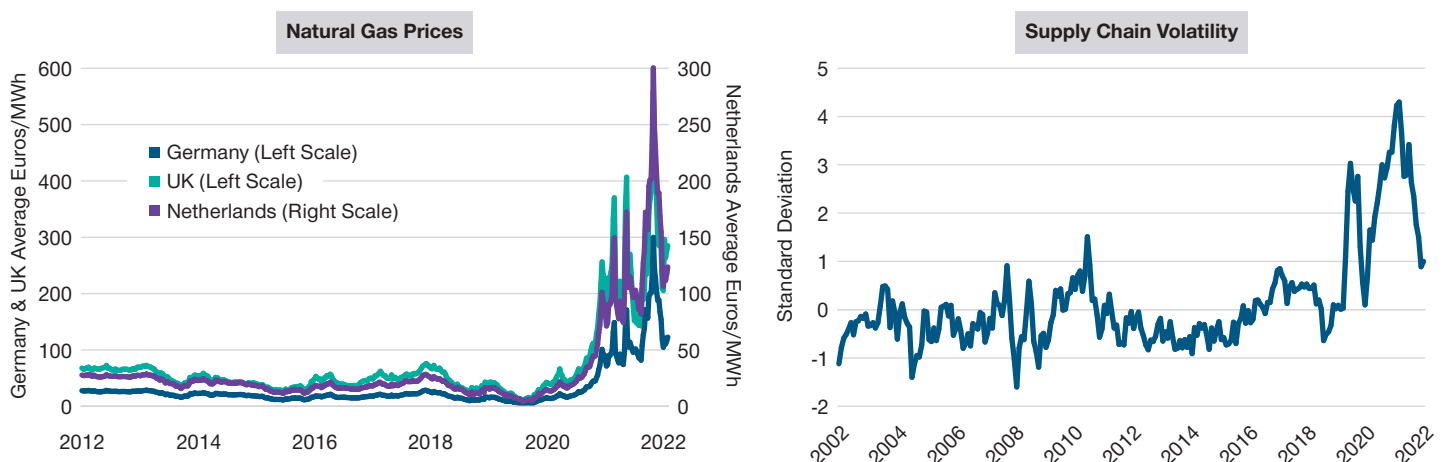
### Global Supply Chains Are Healing

Widespread fears that COVID-related supply shortages could linger for years, strangling global growth, also appear to have been overly pessimistic, Thomson notes. Instead, supply chain reliability improved steadily over the course of 2022 (Figure 5, right).

Moving into 2023 and beyond, supply chains in some industries are likely to be reconfigured to limit future disruptions, McCormick argues. This will impose frictional costs. “I think it supports Justin’s argument that inflation will

## Although Supply Disruptions Have Eased, Geopolitical Risks Remain Elevated

(Fig. 5) Natural Gas Prices by Country and Volatility in the New York Federal Reserve’s Global Supply Chain Pressure Index



Natural gas prices as of November 25, 2022. Supply chain index volatility as of October 31, 2022.

Sources: Intercontinental Exchange/Haver Analytics, Federal Reserve Bank of New York, Liberty Street Economics/Haver Analytics.

“The companies that can carve out important roles in the newer supply chains will be among the big winners.

— Andrew McCormick  
 Head of Global Fixed Income  
 and Chief Investment Officer

be stickier and volatility higher going forward,” he says.

But adaption also will create potential opportunities for investors, McCormick and Thomson say. “The companies that can carve out important roles in the newer supply chains will be among the big winners,” McCormick predicts. “We think it could be the investing story of the next five years, if not the next decade.”

Skilled active management will be critical to take advantage of potential opportunities, McCormick adds. “Individual name selection will be important. The quality of management teams will become really important.”

### A Contrarian Case for China

Investor anxiety about the economic and political future of China, the world’s second-largest economy, weighed heavily on Chinese markets in 2022. Trade and technology conflicts added to investor malaise, as the Biden administration unveiled new export controls designed to restrict China’s access to advanced semiconductor technologies.

“Sentiment about China has never been worse than it is now,” Thomson says.

But Thomson thinks the pessimism has been overdone. His arguments:

- Easing COVID restrictions in China should help clear the way for an acceleration in economic and earnings growth.
- Despite a turn toward stricter market regulation, Chinese government remains committed to a pro-growth agenda.
- Much of China’s growth over the last three decades has come from property development. That era is coming to an end. But different sectors should continue to drive a more moderate pace of economic growth.
- Washington and Beijing both have an interest in avoiding a major break. “A large-scale economic decoupling between the U.S. and China would be a mutually assured depression,” Thomson says. “It’s a frightening thought, but highly unlikely.”

“I understand that these issues will continue to weigh on asset valuations and raise capital costs,” Thomson concludes. “But I think we need to stay objective here, keep an open mind, and watch the data points as they evolve.”

## DEGLOBALIZATION IN A CONNECTED WORLD

| Investment Idea                  | Rationale  | Examples   |
|----------------------------------|--|--|
| Energy Security and “Re-Shoring” | Geopolitical tensions, decarbonization, and global supply chain restructuring are likely to catalyze capital spending in a variety of industries and countries. This should drive demand for raw materials and infrastructure. | <ul style="list-style-type: none"> <li>■ Real Assets</li> <li>■ Global Industrials</li> <li>■ Sustainable Investing</li> </ul> |

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## Summary

The biggest risk right now is liquidity.

— Sébastien Page  
Head of Global Multi-Asset  
and Chief Investment Officer

Entering 2023, investors stand at a major turning point in capital market history. The global economy has passed from decades of declining interest rates into a new regime marked by persistent inflationary pressures and higher rates.

“The era of cheap money, high valuations, and super-high asset returns driven by multiple expansion is over,” Thomson warns.

Regime change clearly presents risks. But markets may have overreacted to some of those risks in 2022, creating attractive potential opportunities for investors willing to be selectively contrarian:

- Valuations in most global equity markets have improved markedly, although U.S. equities still appear expensive relative to their own history.
- Fixed income yields have reached attractive levels, given what appears to be a manageable outlook for credit downgrades and defaults.
- Structural challenges could boost capital spending on supply chains and renewable energy development, allowing investors to seek the new winners.

In this environment, McCormick says, investors will need to be able to blend top-down macroeconomic insights with detailed bottom-up fundamental research. “You’ll have to be able to judge how the big macro changes are likely to filter through the markets.”

Finally, some investors may need to adjust their tolerance for risk, McCormick concludes. “Many of these issues are just very hard to forecast,” he says. “People will have to expect that their portfolios are going to experience volatility.”

### **It’s Not the Heat, It’s the Illiquidity**

The potential for market volatility will only increase as the Fed and other central banks raise rates and press ahead with quantitative tightening, Page warns. “The biggest risk right now is liquidity.”

In 2022, Page notes, bear markets unfolded in two stages. The first was a rate shock as the Fed raised rates from zero to 4% over a nine-month period. This was followed by a growth shock as investors discounted the risk of an earnings downturn.

In 2023, Page warns, investors could face a third bear market stage: a liquidity shock, in which markets decline across the board as leveraged positions are unwound. While painful, such shocks also can create major buying opportunities, he says.

“A liquidity event could mark the kind of capitulation that typically has marked the bottom of a bear market,” Page says. “Those historically have been very strong buy signals.”

Successfully timing a market bottom is notoriously difficult, Page notes. But history suggests investors don’t need to be precise to benefit from temporarily depressed equity valuations.

According to Page, in 17 previous major U.S. bear markets (defined as a decline of 15% or more in the S&P 500 Index), an investor who shifted just 10% of their portfolio from bonds to stocks near a market bottom could have significantly enhanced portfolio returns over the subsequent 12 months—even if their timing was three months early, three months late, or somewhere in between.

Investors may want to be more cautious now, however, Page says. Historically, he notes, the chances of successfully investing around a market bottom were significantly lower when inflation was high and interest rates were rising.

That’s one reason to take a selectively contrarian approach in 2023, Page says: The Fed is no longer backstopping investors by limiting market volatility, a policy known as the “Fed put.”

“When there is no Fed put,” he says, “you want to be a bit more patient about leaning in.”

# 2023 Tactical Views

■ Underweight   ■ Neutral   ■ Overweight

**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**

| ASSET CLASS                |  |   |   |  |
|----------------------------|--|---|---|--|
| ASSET CLASS                | Equities                               | ■   | Stocks remain vulnerable amid tightening liquidity, slowing growth, and higher rates. However, these headwinds should peak and subsequently ease in the latter half of 2023, which may provide an opportunity to add to equity exposures.             |  |
|                            | Bonds                                  | ■   | The balance between central bank tightening, high inflation, and slowing growth could produce rate volatility. Higher yields, especially for high yield bonds, are supported by strong fundamentals and provide a buffer against credit weakness.     |  |
| <i>Equity Regions</i>      |  |   |   |  |
| EQUITIES                   | U.S.                                   | ■   | U.S. equities remain expensive on a relative basis. However, the U.S. economy appears to be on a stronger footing than the rest of the world, and its less cyclical nature could provide support as global growth weakens.                            |  |
|                            | Global Ex-U.S.                         | ■   | Cheaper valuations reflect the current challenges from high inflation, recession risks, and an energy crisis in Europe. An easing of these headwinds and continued fiscal support could provide upside over the course of 2023.                       |  |
|                            | Europe                                 | ■   | Valuations are compelling, but high energy costs and weakening manufacturing activity make a European recession likely. We expect the ECB's resolve on fighting inflation to ease as economic growth wanes in 2023.                                   |  |
|                            | Japan                                  | ■   | Japan offers historically cheap equity valuations, a lower inflation rate, and accommodative monetary and fiscal policy. The cheap yen and an improvement in global trade later in 2023 could support this export-oriented economy.                   |  |
|                            | Emerging Markets                       | ■   | Valuations and currencies are attractive in many markets. Central bank tightening may have peaked. The path in 2023 is likely to remain uneven, but an easing of China's zero-COVID policies could be a significant tailwind.                         |  |
|                            | <i>Style and Market Capitalization</i> |   |   |  |
|                            | U.S. Growth vs. Value*                 | ■   | Relative valuations continue to favor value stocks, and financials and energy sector earnings provide support. Growth stocks remain vulnerable to higher rates but could be viewed as safe havens if U.S. economic weakness intensifies.              |  |
|                            | Global Ex-U.S. Growth vs. Value*       | ■   | As of late 2022, ex-U.S. value stocks were trading at attractive valuations, reflecting tight monetary policy, sovereign debt concerns, and Europe's energy crisis. If these risks are mitigated in 2023, value could provide strong upside.          |  |
|                            | U.S. Small-vs. Large-Cap*              | ■   | Small-cap stocks offer historically cheap valuations, reflecting recession concerns and higher financing costs. A preference for quality is warranted, but small-caps could offer notable upside when the economic outlook improves.                  |  |
|                            | Global Ex-U.S. Small-vs. Large-Cap*    | ■   | Small-cap valuations are attractive across many regions but challenged by the weak growth outlook, inflation, and higher borrowing costs. An improvement in the economic and inflation fundamentals could be a tailwind.                              |  |
| <i>Inflation Sensitive</i> |  |   |   |  |
| Real Assets Equities       | ■                                      | Real assets could remain an attractive hedge if inflation lingers. However, commodity and natural resource equities are vulnerable to global economic weakness—notably ongoing COVID and property market concerns in China. |   |  |
| BONDS                      | U.S. Investment Grade                  | ■   | Yields could peak in the first half of 2023 as inflation cools, allowing the U.S. Federal Reserve to moderate policy. Slowing growth and inflation could support longer-duration bonds. Credit may prove resilient thanks to strong fundamentals.     |  |
|                            | Developed Ex-U.S. IG (Hedged)          | ■   | Interest rates in developed ex-U.S. markets are likely to remain volatile as central banks balance inflation concerns and risks to growth. A slowdown in the pace of Fed rate hikes should narrow rate differentials, softening U.S. dollar strength. |  |
|                            | U.S. Treasury Long                     | ■   | While yield volatility could persist, slowing inflation and easing central bank policy could provide a tailwind for longer-duration bonds.  |  |
|                            | Inflation Linked                       | ■   | A moderation of inflation in 2023 is likely to be a headwind for inflation-linked bonds. However, the sector also offers a hedge against upside inflation surprises.  |  |
|                            | Global High Yield                      | ■   | Strong credit fundamentals should remain supportive in the face of deteriorating economic growth in 2023. In the wake of the bond bear market, higher yields offer attractive income potential and a buffer if credit spreads widen.                  |  |
|                            | Floating Rate Loans                    | ■   | High yields and relatively short duration profiles make floating rate loans attractive in rising rate environments. However, slower central bank tightening and declining short-term interest rates could be headwinds in 2023.                       |  |
|                            | EM Dollar Sovereigns                   | ■   | Yields look attractive relative to the developed markets but reflect elevated global growth concerns. More dovish central banks and signs of improving global trade could support the sector.   |  |
|                            | EM Local Currency                      | ■   | EM currencies and local currency yields are at attractive levels, reflecting cautious investor sentiment. As the U.S. Fed slows the pace of interest rate tightening, EM currencies may benefit.  |  |

\*For pairwise decisions in style and market capitalization, boxes represent positioning in the first asset class relative to the second asset class.

The asset classes across the equity and fixed income markets shown are represented in our multi-asset portfolios. Certain style and market capitalization asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.

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