

Investment success in 2023: Don't play the guessing game



Fabiana Fedeli, Chief Investment Officer: Equities and Multi-Asset and Sustainability M&G Investments (UK)

So far in 2023, global financial markets have experienced some wild swings, dictated by the guessing game over inflation and the path of US interest rates. January's sentiment was dominated by more bullish views of a weaker US economy, softer inflation, lower-than-expected interest rates and a relatively imminent pause to the US Federal Reserve's rate hiking cycle.

This was all up-ended in February by surprisingly strong economic data, including more widely embedded inflation than previously thought. With the Fed signalling its intention to continue hiking, this sent market uncertainty higher and global asset prices lower, an environment that continued well into March.

Then the emergence of banking sector turmoil sparked by the sudden failure of Silicon Valley Bank and the buyout of Swiss banking giant Credit Suisse shocked markets even further, with swift central bank interventions and rescues preventing the contagion from spreading. Central banks now have an even tougher policy balancing act between their duties of fighting inflation, safeguarding global banking systems and supporting growth and employment. Uncertainty has prevailed, and today's investment managers have rarely, if ever, seen such sharp changes in market views in such a short period of time.

This is why, according to Fabiana Fedeli, Chief Investment Officer: Equity, Multi-Asset and Sustainability at M&G Investments (UK), caution is required when investing at the moment, because no one can predict what will happen in the world's largest economies in the short term: recession? No recession? A short lived, shallow recession, or more bank failures and general loss of confidence in national banking systems followed by a wider, deeper recession?

"Even though consensus expectations point to recessions in the US, UK and Europe over the near term," says Fedeli, "GDP growth estimates have been revised upwards, and the odds for recession have fallen. History has shown that previous recessions related to interest rate hikes have occurred with a 5-15-month lag from the last rate increase, and have varied in severity. In reality, no one can be sure about the timing and extent of a downturn."

In such uncertain conditions, she advises, one must avoid the guessing game and go back to fundamentals to determine how best to invest. "We are broadly neutral to underweight in global equities based on prevailing valuations," she cautions. "Now is not the time to take on sweeping country or sector bets. Corporate earnings in the US, UK and Europe have been mixed, but reasonably resilient, generally beating estimates. But global equity valuations differ widely across countries and even within sectors, with individual companies offering a wide variety of dividend and earnings yields. As such, one needs to be selective in choosing equity exposure."

In M&G's view, US equities are more expensive than their counterparts in Japan, China and certain other emerging markets, which offer good value on a relative basis. As such, the group's multi-asset portfolios are overweight the latter markets at the expense of the US, Canada and Australia, among others, and they are carefully diversified to reflect the elevated uncertainty.

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Meanwhile, says Fedeli, global bonds are a relatively safe bet, now offering the highest real yields in 10 years after the recent central bank rate hiking cycle. “Some of these government bond yields are equivalent to equity earnings yields, but with much less risk, so we have been happy to have increased our fixed interest holdings over the last few months. This includes 30-year US Treasuries as a way to offset equity risk, and because real US Treasury yields are generally higher than their European equivalents. Certain emerging market bonds are also offering attractively high yields for the risk involved”, she adds. “Yet our positioning is broadly neutral in global bonds, given the still high interest rate risk prevailing worldwide. Should inflation remain stubborn and continue to surprise to the upside, investors could face more rounds of central bank rate hikes that will further undermine bond prices.

As such, cash remains the preferred global asset over equities and bonds in M&G's multi-asset portfolios for now”, Fedeli reveals. This is for its diversification benefits and to take advantage of any future shorter term opportunities that might arise when assets become mispriced in the current highly volatile environment. The group's portfolios are less overweight cash now than they were in 2022, having used their cash to buy more global bonds (and equities to a lesser extent) as these assets became cheaper in recent months as part of their active management approach.

In conclusion, says the CIO, “in our view, despite the highly uncertain environment, there are ample opportunities to generate above market returns going forward by using a relative value approach across both global equities and bonds. There is no need to try to predict the next direction of interest rates or the likelihood of a recession and take directional bets. Instead, focus on fundamental valuations of specific stocks and bonds, be sure to stay carefully diversified, and make volatility your friend by using short term mispricing to add high quality assets at attractive valuations”.

