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CIO Update:
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Aoibheann Treacy: Lenny, can you provide an overview of the economic and inflation backdrop and how that has evolved through Q1 and how expectations for central bank policy have been impacted by these developments?

Lenny: Absolutely. So, firstly, growth has been better than expected – with China reopening, European sentiment and activity improving, supported by lower gas prices and better recent momentum in US economic data.

Secondly, inflation has clearly peaked as supply-chain pressures ease and energy prices have fallen. The pace of moderation in inflation, however, has been slower than expected as tight labour markets cause services inflation to remain sticky, even as goods price disinflation is evident.

Finally, recent stresses in the banking sector have created concerns over a potential credit crunch with possible negative repercussions for growth and renewed fears of slowdown/recession. Expectations around central bank policy have been fluid, impacted by inflation developments and bank stresses.

Aoibheann: Anthony, how do you think the banking situation is likely to evolve and potentially impact the economy and central bank policy?

Anthony: We would highlight that we have experienced the most aggressive tightening cycle by central banks since the 1980s which is having a lagged impact on growth and inflation and giving rise to the risk of vulnerabilities in the system, as highlighted by the LDI issues in the UK last year and recent stresses in the bank sector. I think it is important to state that Silicon Valley Bank was unusual in terms of its concentrated, uninsured deposit base and mismanagement of its securities portfolio, and is not representative of US or wider global banks. Credit Suisse also in its own right was a special case with pre-existing underlying difficulties. The European banking sector is relatively better positioned, and we have seen a swift response from authorities on both sides of the Atlantic which has helped contain the spreading of risks.

Concerns are still evident regarding the sector – not to the extent this could be another GFC or that it represents systemic risk to the sector, but we are monitoring events closely.

US regional banks are in the eye of storm and critical to the US economy and recent events may mean:

- tighter lending going forward
- lower risk appetite
- increased funding costs for deposits
- increased regulatory oversight

All of which are likely to lower economic growth, which means central banks are faced with a choice between still high inflation and increasing financial stability/growth risks. Investor expectations for central bank tightening have changed recently and investors now expect three rate cuts by year-end in the US after possibly one more 25 basis point (bps) rate hike. In Europe, further rate hikes had been priced in but the ECB has indicated future decisions will be data dependent.

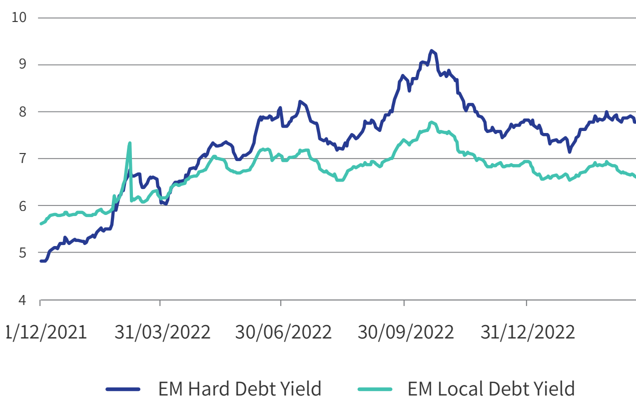
Aoibheann: Given the current backdrop, how can investors navigate this uncertainty and how have we incorporated this in our portfolios? Are we seeing opportunities emerging?

Anthony: As per our Investment Outlook at beginning of year, the most immediate opportunities appear to be in fixed income markets with repricing over the last two years now providing attractive entry levels for investors.

We believe fixed income assets offer opportunities both from a value and point in the cycle perspective. Historically, from current yield levels, fixed income asset returns have been strong over the following 12-24 months. With central bank rates looking to have peaked, inflation continuing to decline and growth concerns remaining, we think yields may reduce over the next 12 months, providing scope for capital gains in addition to the high income stream from the higher yield environment.

Specifically, we see opportunities in emerging market (EM) hard debt yielding 7.8% and investment grade (IG) corporate bonds yielding 4.0%, and we have increased our exposure to fixed income over Q1 to take advantage of these higher yields on offer.

EM Debt Yields



Source: Bloomberg

Aoibheann: Lenny, within equities are there opportunities we are seeing and particularly across regions?

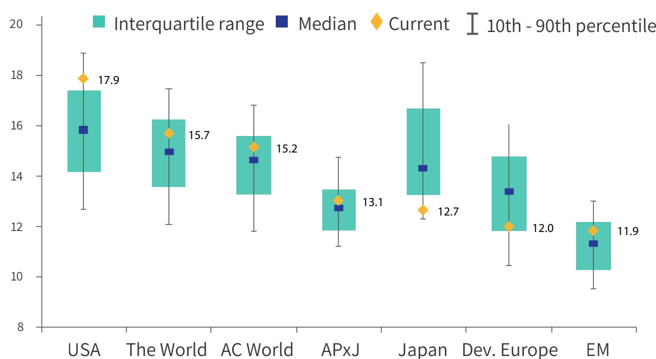
Lenny: Equities have also repriced significantly and are discounting a lot of bad news, with P/E valuations more attractive at 15.2x versus their long-term average of 16.0x (average since 1987). However, equities are likely to remain volatile in the short term due to:

> questions over the outlook for growth

> earnings risk from margin pressures

While some caution is warranted in the short term, overall we think equities provide attractive return opportunities over the medium to long term.

Valuation ranges (MSCI Regions) over a 20-year timeline
12m fwd P/E multiple



Source: Factset, Goldman Sachs Global Investment Research

The resetting of prices and valuations over the last 15 months has allowed us to recently update our long-term return expectations across several assets, including equities and return forecasts are much improved compared to previous estimates.

We see global equities delivering 6.1% per annum on a 5-10 year view, with a preference for non-US markets, which we see outperforming the US by approximately 2% per year in coming years. In particular we see opportunities in Europe, which is trading at the lower end of its 20-year valuation range, and it offers exposure to the value style, which we prefer over the medium to long term. Emerging markets also look attractive, trading at a large absolute discount to global markets while offering a growth premium. Small cap stocks also represent an opportunity over the medium term, trading at a discount relative to their long-run average versus large cap stocks while having a history of long-term outperformance.

Aoibheann: Anthony, so what are the key takeaways for our audience to consider?

Anthony: I would say that the constantly evolving backdrop and occasional unexpected event is likely to contribute to ongoing volatility.

Given current uncertainties, we are conscious of fatter tails in the distribution of outcomes. In this environment, investors need to stay disciplined and risk aware. We have seen the benefits of diversification in the last few years and they will remain critical through the current period of heightened uncertainty and the fluid backdrop in terms of both the macro and geopolitical perspectives.

In terms of how we're designing our portfolios and thinking about investment opportunities and managing risks, we are seeing opportunities in fixed income from a risk management and value and return perspective. Within equities there are also diversification benefits to be obtained and we see opportunities in higher quality, defensive, strong cash flow businesses and also see opportunities in specific regions and small cap equities.

We should be humble at major turning points and recognise that in four of the last five occasions that the US Fed stopped hiking rates, the equity market rose strongly thereafter. As a result we should not necessarily become over defensive and so, for us, it's really about staying disciplined, staying risk aware and staying diversified to navigate these uncertainties going forward.

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