

Exchanges at Goldman Sachs

Asset Allocation Outlook for 2023: Greater Diversification and Divergence

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Allison Nathan: Market volatility, inflation, and positive correlations across assets have put the diversifying nature of multi-asset portfolios in question.

Christian Mueller-Glissmann: We feel that, going into next year, there's a good chance that 60/40 portfolios remain volatile, and you're not getting necessarily back to the type of regime we've been accustomed to in the last 20 years where such a strategy was a relatively robust way to essentially construct a portfolio.

Allison Nathan: I'm Allison Nathan, and this is Exchanges at Goldman Sachs. To better understand the factors that investors should keep in mind when building portfolios, I'm sitting down with my colleague Christian Mueller-Glissmann, who heads asset allocation research

within portfolio strategy. Christian, welcome back to the program.

Christian Mueller-Glissmann: Thanks for having me again.

Allison Nathan: So let's start with a review of 2022. We've seen sharply higher interest rate yields and a leadership change in sectors as the high-growth tech sector underperformed and energy and commodities sectors took the lead. So give us an overview of how assets and investment styles have performed this year.

Christian Mueller-Glissmann: Yeah, it's been a remarkably difficult year. I think you've had very few assets do really well up until recently where you had a bit of relief, and it was really down to starting point with everything being expensive at the beginning of the year. And why was everything expensive? It's because you had real yields, sort of bond yield after inflation, last year turned deeply negative, boosting valuations across assets. And I think a lot of that reversed. You had a sharp increase in real yields that weighed on most assets. But in particular, as you said, on long duration assets.

So tech stocks, growth stocks did really poorly. FANG, the famous acronym, I think one of the worst-performing group of stocks. But also assets like Bitcoin and crypto that have a certain amount of duration correlation with these type of areas have done really poorly.

And the trigger, of course, of these rising real yields was a lot related to inflation and the inflation shock that further accelerated with the Russia-Ukraine invasion, and that really boosted commodities. Commodities were already strong before because you had the reopening boost, but I think commodities were by far the brightest spot in portfolios this year, providing one of the few areas that have been resilient on delivering positive return.

The last thing worth mentioning in terms of performance has really been related to that to some extent has been the dollar. If you think about the dollar, it's another asset, dollar cash at least, that has actually performed remarkably well this year. In part, because of the energy crisis where the US has been suffering a bit less.

Allison Nathan: So let's drill down a bit more into

equities. This year is likely going to go down as another very volatile one for stocks. So do you expect that to continue?

Christian Mueller-Glissmann: It's really interesting you say that it's been a very volatile year for stocks, but the VICS [sp?] has never really gone above 40. Obviously we're in the middle of a bear market. We've had a decent amount of relief now, which is quite remarkable I think. The draw down year to date has reversed quite a bit in the last few weeks. But it's been a volatile year, but it's been to me I always say it's been like more slow tail risk.

Like, when I look at the last cycle and, to be honest, the last 20 years, you were dealing with these really fast and sharp draw downs in equities where you would have the VICS spike above 45. And to some extent, these bear markets as a result of that were also quite short because they were short and painful, but then you had recoveries. Whereas this time, it's been much more prolonged. And to some extent, it's related to the source of the risk.

As I mentioned, the source of the risk has been rates. Actually cash flow volatility and growth risks year to date

have been, to some extent, lower than most people would have expected. It's really been a sharp increase in real yields. And if anything, the volatility in the bond market is the big outlier. We're looking at some of the largest number of tail events you had in bond markets in a long time, which then spilled over to equities.

And the interesting thing about the source of the shocks in bonds is obviously inflation. And inflation is, I always say it in technical terms, it's very auto correlated. In very simple terms, it's just trending. It trends for longer. It trends for a long period of time. And that means that, to some extent, the price momentum trends a bit longer. And that has meant that you are not dealing with one sharp draw down and you're done with. It's like a few several shocks that have been trending in the same direction and ultimately weighed on equities.

So to answer your question on volatility for next year, I think next year could be a bit more traditional in the sense that we think the kind of frustration will move a bit away from inflation and rates volatility where we have a lot on the table now with regard to both what's priced but with regards to how high inflation has gotten to. I think there's

a clear expectation that inflation will normalize.

But if you then shift over to growth volatility, that can then continue to keep equities volatile and possibly drive some of the type of volatility we're accustomed to because, when you actually have a growth shock, the risk of some type of second round effects like negative convexity, the market really worrying at the VICS going above 40 is a bit higher, I would say. And it depends a bit as well on how healthy the private sector is, how many imbalances you have, how much market stress you actually generate, and there's some encouraging signs. We know that the private sector is a bit healthier, and there might not be as much deleveraging pressure. But we certainly would argue next year is more about growth volatility, and that's likely to continue to keep equities quite volatile.

Allison Nathan: And with the equities sell-off this year, we have seen valuations come down a bit from their highs. So do you see that creating enough of a cushion in equity assets that we could see some upside in 2023? You mentioned that we have seen a bit of a rally recently. Do we think that we are off the bottom and the worst is behind us at this point?

Christian Mueller-Glissmann: Yeah, I mean, it's typically when you write the outlooks, I think you want to do an outlook for the next year. And to some extent, things happen in the weeks in the run-up to the end of the year, and certainly based on just the valuation reset we had this year, you could have been a bit more constructive for next year. Certainly, equity valuations have de-rated materially alongside rising yields, so we are below the average valuations since the '90s.

We can of course ask ourselves if the average since the '90s is the correct benchmark, considering the world we live in with regards to inflation being much higher than what we had since the '90s. And maybe some other risks with regards to either the late cycle position in the US or geopolitical. Of course, we can all debate that, but I think valuations have reset a lot over the course of the year, and that should make us more confident for next year that the starting point is better.

But as you said yourself, I think we've seen significant amount of relief already in the last few weeks, partially because the market has pulled forward some of the hopes

for inflation normalization, some of the hopes for peak inflation, peak rates, peak hawkishness, and with that, to some extent also, the fears of a recession have receded. So my sense is that the valuations where they are right now don't give you that much of a cushion because you always want to look at the valuations not just in isolation but also in the context of the macro conditions.

And we do have a model, for example, that combines valuations with the type of level of growth the market has to work with, and it gives us a probability of a correction. And based on our economists' view that US growth will avoid a recession but it will still move below trend, coupled with the level of valuations where we're at right now, we would still say that there's a decent probability that we will get another draw down in equities in the coming months.

And the key challenge we have is of course that everybody knows that growth is likely to be weaker next year, and usually markets trough ahead of the growth. And that's why investors, to some extent, might want to move on already from some of the negatives that we might be facing. But we feel that it's too early. I think we don't know the full extent of growth damage. We don't know the full extent

of corporate damage because, even if the economy avoids a recession, you could argue that the corporate sector will still deal with a very tough set of macro variables with regards to margins being at peak, unemployment being very low, and the actual end demand, even if it's not going into recession, is slowing. That's normally not a good backdrop to operate with.

And valuations to us don't reflect that. The best way to summarize is also the equity risk premium. How much excess return can you expect from equities relative to bonds? And if you look at different models for that, it looks quite low right now during the type of risks I mentioned earlier.

Allison Nathan: Well, because many assets actually largely moved in the same direction this year, the #of traditional multi-asset portfolios were severely challenged. The 60/40 portfolio -- 60% stocks, 40% bonds -- actually had one of its worst results in years. So if you think about everything you've just said, do you expect that poor performance to continue?

Christian Mueller-Glissmann: This year was very tough

for multi-asset investing, full stop. And we wrote about this in our balance [UNINTEL] research quite a bit. It had a lot to do with the valuation starting point when both equities and bonds were expensive at the same time. And that very seldom happened in history, and then you had this shock coming from the inflation and from the rates side.

To your question, now do we expect that to continue? Again, the answer a few weeks ago would have been we're in a much better spot because bond yields have repriced quite a bit, so they give you more buffer. And equities are at a lower valuation, so the two of them, they can help each other a bit more. If there's further growth shocks emerging, like growth volatility, the bond market can buffer you a bit. And if there's rates volatility, maybe the equity market can benefit a bit in case of inflation feeding into growth in some shape or form.

But now I think both bond yields have come down quite a bit in anticipation of, yeah, peak hawkishness, as I mentioned, and the market has faded to some extent cyclical concerns, both across assets with risk premia for equity and for high-yield credit, but also within assets with,

like, cyclicals versus defenses, not discounting that much risk. So I think you have, again, a situation where, especially going into next year, you could see a bit of a replay where, if you get a rates shock because the Fed needs to continue to fight the labor market strength in a more vigorous way, there's very little cushion in equities for such a rate shock. And if you do have a growth shock, the bond market, as it rallied already quite a bit, might not help equities much.

So we feel that, going into next year, there's a good chance that 60/40 portfolios remain volatile, and you're not getting necessarily back to the type of regime we've been accustomed to in the last 20 years where such a strategy was a relatively robust way to essentially construct a portfolio.

Allison Nathan: And if we look at the bond side in a little bit more detail, you've obviously, as we've been discussing, seen a sharp increase in bond yields. And they're suddenly looking more attractive. The gap in yields between stocks and bonds has narrowed, so is it time for investors to allocate more to bonds?

Christian Mueller-Glissmann: Yeah, I think there's definitely more opportunities in fixed income emerging right now. More up in quality. And it's important to rethink the role of bonds in the portfolio. It's less about the bond market providing you a buffer. It's less about negative equity bond correlations and diversification benefit you get from fixed income. As I mentioned, that might take a bit of time to regain that. And it's not just the fact that yields have come in a bit, but I think in a more kind of, like, longer term perspective, the level of inflation you're operating with, like headline and core, is still so high that we feel the central bank put this idea that central banks come to the rescue is not that reliable at this juncture. So it could take some time to get back to that type of role for bonds in the portfolio.

But bonds can have another role in the portfolio, which is to generate returns. And I think that is coming back. And that's something which we haven't had in a few years. We always say that there's been a shift from TINA, There Is No Alternative, where people were forced up the risk curve to equities, to higher risk credits, to TANRA, There Are No Reasonable Alternatives, no? And I feel like, if you are a multi-asset investor, you look at investment-grade credit in

the US, you can easily have a 6-7% yield right now, and you have to consider with type of volatility. Because equities are a risky proposition and, yes, maybe they deliver positive returns from here, let's say 8-12%, which is not far from what our forecasts are for global equities. We see less upside for US equities. But let's say you get 8-10%.

But then you have to consider that investment-grade credit has roughly a third to a fourth of the type of volatility that equities offer, and that just tells me that fixed income currently is a very good place to get paid to wait. Because we all know that equities, in the long run, have the best return potential, and it's always the trade-off in asset allocation between living well and sleeping well. With equities, we don't sleep well, but we know in the long run we live well. But there can be tactical opportunities to maybe be a bit more up in quality, a bit more defensive, and we think that's still the case, especially after the relief rally we've just had.

Allison Nathan: And so if the performance of 60/40 portfolios still looks shaky heading into 2023, what should investors look to for diversification benefits?

Christian Mueller-Glissmann: Yeah, I mean, the role of alternatives certainly has picked up significantly over the course of this year. And there's two areas where we've seen a lot of client interest. One of them is larger allocations to real assets, and that has a lot to do with the resurgence of inflation and inflation risk, where there's not just a concern that inflation will be higher in the coming years, but there's a concern that it will become much more unpredictable and much more volatile.

And if you have a nominal asset, the inflation volatility feeds through to the nominal cash flows, of course, in some shape or form. Whereas a real asset has real cash flows, so the inflation shouldn't necessarily impact it, especially if it's explicit real assets like infrastructure, for example, where cash flows might be contractually linked to inflation. So we've seen a lot of focus on that, especially from a strategic perspective to look at allocations here.

And I think it's been a tough year in some of those areas. Think about real estate, which has a leverage issue of course. Or think about commodities, which, outside of energy, have been very volatile. And even energy has been

volatile recently. But there's a certain recognition that more allocation to real assets partially via private markets because they're not so easily accessible makes sense.

And the other main area has been areas to reduce risk in the portfolio via alternatives. So that's in particular looking at hedge funds or looking at trend-following strategies like CTAs. So CTAs, essentially long-short strategies that focus on capturing momentum across assets, and I think really focus on the idea that macro momentum offers more [UNINTEL] and that creates ability to generate positive returns. That's been clearly an incredibly successful story this year. It has a bit to do with what I mentioned earlier, that this year markets have trended a bit more. It's been less fast, aggressive moves. It's been more macro momentum feeding into price momentum gradually. So trend-following strategies have become a real diversifier, and it is a lot linked to inflation we've found historically that's been the case as well to some extent in previous periods of higher inflation.

So I think we certainly see investors think about alternatives as a bit of a solution, but it's a slow-moving process because there's not always the liquidity and it

takes time to get these type of things in the portfolio. But certainly we see more in that direction.

Allison Nathan: Let me ask you about the shape of the yield curve. There's a lot of focus on the fact that the treasury yield curve is now inverted, so that yields on longer term treasuries are below those on short-term bonds. So what, if anything, is that signaling about the outlook on inflation and future rate cuts? Should we take anything away from that?

Christian Mueller-Glissmann: There's [UNINTEL] signals, and it's always tough to completely disentangle. It tells you that you are in the middle of a Fed tightening cycle where the front end is pushing up, and the back end, to some extent, reflects some type of reversal of that. That reversal could be triggered by a recession, of course. And that's historically how you would interpret the kind of inversion of the yield curve and further flattening to these deeply extreme levels.

And what's interesting with regards to the yield curve right now is not just that one part of the yield curve -- like, for example, two-tenths spread -- is deeply inverted, but a

large amount of the yield curve is inverted. I think 80% or so. So it tells you there's a certain amount of mean reversion, the markets pricing in rates, which clearly reflects to some extent recession risk. And if you just look at the two-tenths spread, based on our recession probability model, it gives you a 90% probability that you get a recession in the next 12 months, which is much above what our economists are forecasting.

But there can be other things that the yield curve reflects. It could also reflect some type of normalization of inflation in the long run, and certainly breakeven inflation has been remarkably anchored in the back end. I would actually argue that it's more recession risk. It's more a late cycle position the US economy has. We have similar signals coming from the labor market, of course, where the unemployment rate is incredibly low right now. We have similar signals coming from profits and profit margins that are at all-time highs. So to me, I think the yield curve is telling us something we all know, which is that the US is hot, the economy, and that there's some potential slowdown. And some of that slowdown has a certain probability of being a recession.

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Allison Nathan:

And you mentioned the strength of the dollar, so US assets have probably outperformed other countries this year largely because of that strong dollar. But our economists think that the dollar is likely to peak in 2023. So what does that mean for regional diversification? Should investors be looking to put more assets to work abroad?

Christian Mueller-Glissmann: Yeah, it's a great question. It certainly is a big change potentially for this year where it's been particularly tough for US investors because, if your portfolio is denominated in dollars, you clearly with the dollar strength, you have to be close to home. You have to be close to home but not only that. As the US equity market is a long-duration equity market, so with that type of increase in real yields and stronger dollar, you don't just have to be close to home, you have to be in short duration equity. You have to avoid these areas that have suffered from higher real yields in the US. That next year could be quite different.

There's plenty of opportunities outside of the US. If you look at equity valuations, for example, sector-neutral, adjusting the valuations sector by sector, you will find that

European, Japanese, and EM equity trade at some of the largest discounts we've seen in a long time. And if you now have the currency being less of a headwind and less of a concern, especially for US investors, there might be more opportunities for international diversification.

But generally what we would argue and we've cited a lot in our research as well is we might be entering a kind of few years of more divergence. And what I mean by that is you have inflation divergence, and that's clear the US has an inflation problem which is particularly linked to services and the labor market. Whereas in Europe and a lot of other places in the world, the inflation is linked to energy. That could potentially drive major divergences in the inflation picture. And related to that in monetary policy and FX, it can also drive significant cycle divergence.

And we have of course China being a very interesting potential divergence story next year where developed markets are starting to move below trend or Europe is in a recession most likely right now and possibly flirting with pretty poor growth for a few months. Whereas China, because of the zero-COVID policies, has a kind of reopening story. So my sense is next year there will be

more diversification opportunities. The dollar peaking on at least not being as strong anymore makes it for a larger amount of investors globally possible to even think about region diversification.

It might surprise a lot of people, but if you look at local currency returns, Japan has been the strongest equity market this year. But clearly if you were investing into Japanese equities in yen, so unhedged, you would have performed just as well as you did with the S&P. So my sense is that, as soon as you take the currency component out and you have more optionalities on the currency, I think it creates plenty more opportunities to think about diversification, either because of tactical and momentum, like maybe a China reopening trade, or because you think that areas like Europe from a valuation point of view just give you interesting opportunities for the long run to pick up some attractive assets.

Allison Nathan: So let me close by asking you which asset you see as most mispriced right now.

Christian Mueller-Glissmann: Yeah, as I mentioned earlier, to me, the big problem you have is a certain cyclical

optimism across assets that has really come back in the last few weeks because of peak [UNINTEL] and peak inflation. And there's a variety of trades linked to that, but to me, literally all cyclical risky assets are vulnerable. So equity risk premia are too low. High-yield credit spreads are too tight. And cyclical versus defensive equity, in my opinion, have recovered too much.

So broadly, we would lean against the cyclical optimism in breadth. There will always be opportunities, as I mentioned, related to China reopening, related to specific areas that have pricing power, that have demand. But we think, in aggregate, we're dealing next year with a kind of shift from inflation and rates volatility to growth volatility. And you don't want to overpay for growth too early. It's always right if you are in the middle of a recession that markets will recover much earlier and you pre-pay for the recovery. But the fact that the market is already pre-paying before having seen the slowdown, it just seems too early.

So I would say that the cyclical assets broadly have gone too far.

Allison Nathan: Christian, it's always great to speak with you. Thanks for joining us.

Christian Mueller-Glissmann: Thanks for having me, Allison. Great to be on, as always.

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