EQUITY OUTLOOK – BRACE FOR VOLATILITY AS INFLATION MEETS RECESSION

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2023 has been ushered in with a rebound in pockets of equity underperformance from 2022. Markets are coming to terms with the fact that stickier inflation and more resilient economic data globally are likely to keep central banks busy this year. Owing to which the spectre of interest rates staying higher for longer appears to be the dominant theme for the first half of 2023. Global money market curves are re-pricing higher to reflect the tighter monetary scenario.

For the Federal Reserve (Fed), markets have priced in a 5.5% terminal rate, somewhat higher than was suggested by the median dot plot back in December. While in Europe, 160Bps of additional rate hikes are being priced for the European Central Bank (ECB) with terminal rate forecasts approaching 4%. The speculative frenzy witnessed since the start of 2023, indicates that equity markets are discounting the fact that the global economy has not faced such an aggressive pace of tightening in more than a decade and the ramifications, although lagged, will eventually be felt across risk assets.

Preference for international vs US equities

Exchange-traded fund (ETF) flows since the start of 2023 resonate investors' preferences to diversify their portfolios with a higher allocation to international markets versus the US. Since the start of 2023, international equity market ETFs have received the lion's share of inflows, amounting to US$20.6bn in sharp contrast to US equity ETFs that suffered US$9.3bn in outflows.

		International Markets ex- US			
Metrics	US	China	Asia-Pacific ex-Japan	Europe	Emerging Markets
Performance	5%	6.1%	4.0%	9.2%	3.9%
ETF net Flows (Year to Date)	-9.3	1.2	2.1	11.1	14.1

Source: Bloomberg, WisdomTree as of 06/03/2023. Net ETF flows are in billions, US dollar.

Historical performance is not an indication of future performance and any investments may go down in value.

Looking back over the past decade, US companies outpaced international stocks owing to two main drivers of equity price appreciation: earnings and valuation. Earnings remain the key driver for equity markets over the long term. If we try to think about what lies ahead, we can see that earnings revision estimates are displaying a marked turnaround for China, Japan, and Emerging Markets (EM), whilst the US and Europe are poised to see further earnings contractions.

China's recovery remains the important swing factor that could enable its economy, alongside EM and Japan, to outperform global equities in 2023. At 8% of sales, Europe has the second highest exposure after Asia-Pacific (ex-Japan) to China. Yet it's important to bear in mind that European companies earn twice the amount of revenue from the US than from China. So, a soft landing in the US will be vital for Europe to continue its cyclical rally.

Source: Bloomberg, WisdomTree, as of 28/02/2023.

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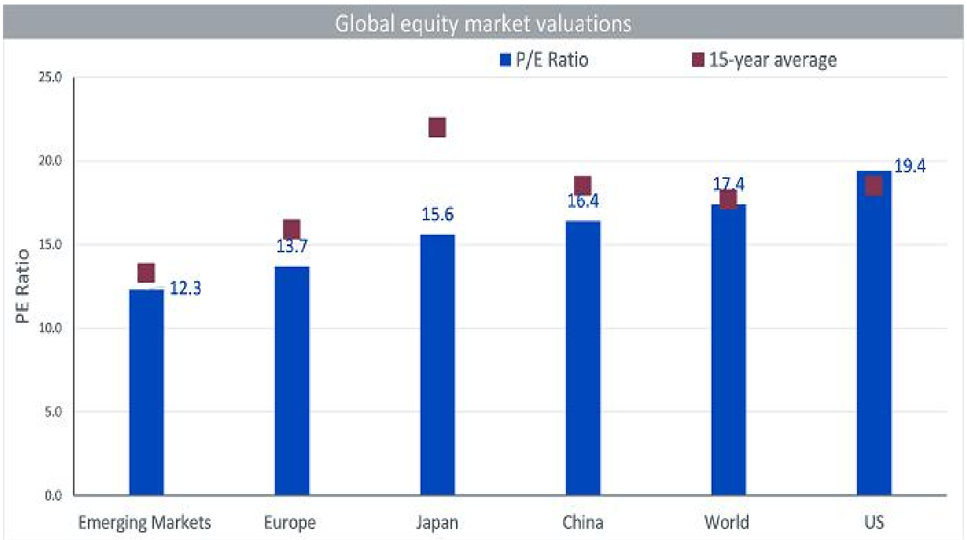
US valuations remain high vs international developed and EM equities

US equity market valuations from a price-to-earnings (P/E) ratio remain high globally, whilst Japan continues to trade at a steep 29% discount to its 15-year average. Amidst the recent rally, European valuations at a 13.7x P/E ratio remain at a 14% discount to its 15-year average. That being said, three months ago European equity valuations were trading at a 35% discount to its 15-year average. After travelling half the distance to their long-term average, European valuations might have to contend with the headwinds of tighter monetary policy.



Source: Bloomberg, WisdomTree, as of 06/03/2023.

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Evident from the chart above, international markets ex-US continue to boast of favourable valuations allowing for a higher margin of safety, which is why we expect investor positioning to tilt in favour of international markets ex-US over the course of 2023.

The battle between Energy and Technology stocks

The Energy sector is coming off a strong year, as tight supplies and rising demand drove energy prices higher in 2022. While these dynamics have failed to play out so far in 2023, owing to the speculative frenzy in riskier parts of the market, we expect earnings results for energy companies, and their stock performance across the spectrum (including oil, gas, refining and services), to maintain momentum in 2023. Whilst investment in oil and gas production has been rising, it will still take multiple years for global supply to meet demand, which continues to support the narrative of higher energy prices.

Refining capacity continues to look tight this year, given the reduced capacity and long lead time required to bring new capacity online. We expect this to support another strong year for the profitability of refining operators. At the same time, energy service companies should also benefit as spending on exploration and production continues to gather steam. The biggest risk to the sector remains if demand for energy falters in the face of a severe recession. However, as we expect most economies to face a modest recession, this risk is less likely for the Energy sector.

Performance comparison of sectors in the S&P 500 Index in 2023 versus 2022

Factors	Tickers	Sectors	Earnings Growth Q4 2022	Performance (since start of 2023)	Performance in 2022
Value	S5FINL Index	Financials	-12.86%	6%	-12%
	S5INDU Index	Industrials	36.15%	4%	-7%
	S5ENRS Index	Energy	54.48%	3%	59%
	S5CONS Index	Consumer Staples	-2.65%	-2%	-3%
	S5UTIL Index	Utilities	-12.63%	-4%	-1%
Blend	S5HLTH Index	Health Care	-5.94%	-3%	-4%
Growth	S5TELS Index	Communication Services	-25.55%	13%	-40%
	S5INFT Index	Information Technology	-9.24%	13%	-29%
	S5RLST Index	Real Estate	7.61%	9%	-28%
	S5MATR Index	Materials	-24.48%	6%	-14%
	S5COND Index	Consumer Discretionary	15.20%	14%	-38%

Source: Bloomberg, WisdomTree as of 6 March 2023.

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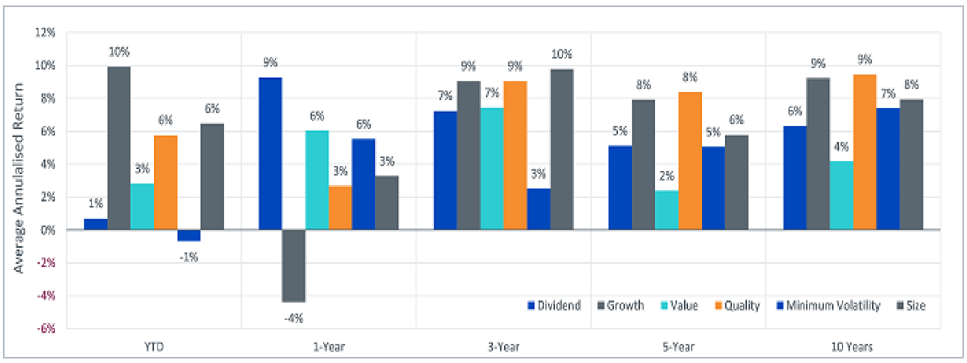
Meanwhile, higher interest rates were the key driver of the underperformance of the Technology sector last year. We continue to see weakness in the Technology sector amidst rising risks of peak globalisation, weaker earnings, and the potential for more regulation. Despite the recent layoff announcements by technology firms, they still appear inflated, with employee growth in recent years 20% too high relative to real sales growth. The COVID-19 pandemic had accelerated the demand in software and technology spending with the rise of remote work and social distancing. However, companies today are more likely to cut their technology spending to offset the higher costs of energy, travel, wages, and other factors. The key risk, in our view, remains that valuations have come down, and if rates do begin to peak, selective technology companies could benefit from the growth generated by their cost-cutting initiatives.

Value vs Growth in 2023

Value stocks tend to be positively correlated with higher inflation. In 2022, high inflation was a result of rising commodity prices, labour shortages, and fiscal stimulus provided by Western economies, whilst Growth stocks were penalised for their lofty valuations. Value-based stocks flourished on commodity supply constraints and cheaper valuations amidst a rising rate environment. Much of this is now priced into Value stocks. Most Value stocks' earnings growth and valuation re-ratings rely on higher commodity prices or interest rates or a factor outside of their control. Owing to this, we still believe there are opportunities where constrained supply in the absence of falling demand will continue to support higher prices.

Sharp reversal of factor performance in 2023 versus 2022



Source: Bloomberg, WisdomTree as of 6 March 2023.

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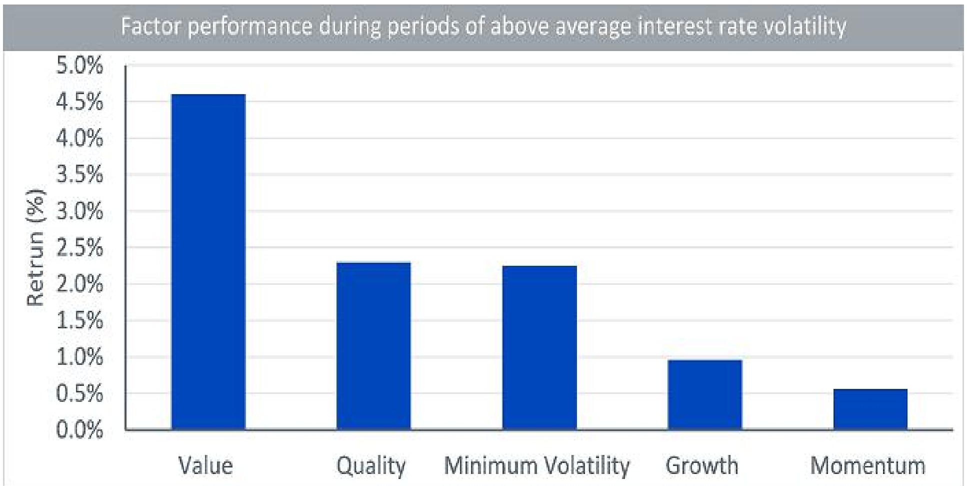
There are significant prospects in Europe and Asia where discounts remain wide and sizeable valuation gaps exist across sectors. Europe's energy sector accounted for two-thirds of Europe's EPS (earnings per share) growth in 2022. The continuing trend of capital discipline, resilient earnings, and high shareholder returns should keep attracting flows into the sector in 2023. We expect Value stocks to be in better shape to withstand the global economic slowdown. Historically, the Value factor has demonstrated resilience during periods of interest rate volatility.



Source: WisdomTree, Bank of America Securities, Bloomberg, data from 01/01/1990 to 31/01/2022; annualised relative performance versus an equal-weighted index.

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Conclusion

There is considerable uncertainty about how 2023 will unfold. As the key focus moves from inflation to a recession in 2023, it opens up the possibility of several outcomes for central banks and interest rates. Keeping this in mind, 2023 may well be a tale of two halves, with higher interest rates in the first half, followed by lower rates in the second half as a global recession takes centre stage.

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