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2023 Midyear Investment Outlook: Soft Landing, Hard Choices

Jun 13, 2023

Investors should consider high-quality long-duration bonds, equities in Japan and emerging markets, and mortgage-backed securities through the end of 2023.

The global economy should slow and become more divergent in the second half of 2023, thanks to persistent inflation and tight monetary policy by central banks. In this environment, investors will be challenged to find opportunities that earn more than the risk-free rate of return—or the Federal Reserve's current policy rate of 5.2%. For investors, this may require varying strategy by region—playing more offense in Asia, and defense in the U.S. and Europe.

"This means hard choices for investors," says Andrew Sheets, Chief Cross-Asset Strategist for Morgan Stanley Research. He cautions that equities and high-yield bonds in developing markets are particularly risky but says investors could find some underappreciated opportunities. For example, agency mortgage-backed securities, whose spreads—the difference in yield relative to Treasuries—are near where they were during the financial crisis in 2008. Crucially, however, they are less risky now because of more conservative lending standards. "With valuations near 2008 levels, and expectations of declining U.S. government bond yields, total returns may be simply too attractive to pass up," Sheets says.

Although the global economic recovery will be sluggish, there are significant regional differences, which will be reflected in regional investment opportunities. "More broadly, Asia should see much

Other takeaways from Morgan Stanley's midyear investment outlook include:

- **U.S. and European equities could lag:** Company earnings are likely to fall short of expectations in the second half of this year. Morgan Stanley strategists lowered their 2023 S&P earnings forecast to $185—versus $222 for the consensus— but expect earnings to rebound in 2024.
- **Japan and EM equities look attractive:** Stronger growth, lower inflation and easier policy in those markets, in addition to reasonable valuations, could deliver double-digit returns over the next 12 months.
- **Sector-level investments offer opportunity:** In the U.S., strategists favor defensive stocks, such as consumer staples, over cyclicals, such as consumer discretionary and technology stocks. Analysts do see upside for technology stocks in Japan, emerging markets and Europe. Finally, investors should consider healthcare in all regions.
- **Investors should be selective with bonds:** Long-duration government bonds in the U.S., U.K., and Germany could perform well, with attractive real yields, despite high inflation and poor carry (i.e. the difference between a bond's yield and the cost of borrowing to invest in it). Meanwhile, soft economic growth without a recession in developed markets suggests that investment-grade bonds could be defensive and provide positive returns.
- **U.S. dollar should stay strong:** In currency markets, the U.S. dollar appears attractive as investors are drawn to its defensive qualities—historically it's had a negative correlation to equities—and positive carry, meaning investors can earn additional return by owning the currency or dollar-denominated assets.
- **Commodities return to normal:** After a breakout 2022, commodities markets are reverting to more normal conditions. Broadly speaking, strategists think prices for most commodities will be flat this year, given that slower economic growth tends to mean less demand for base materials and energy.

For more Morgan Stanley Research on the global economic outlook, ask your Morgan Stanley representative or Financial Advisor for the full report, "Global Strategy Mid-Year Outlook: Crunch Time" (June 4, 2023). Plus, more Ideas from Morgan Stanley's thought leaders.

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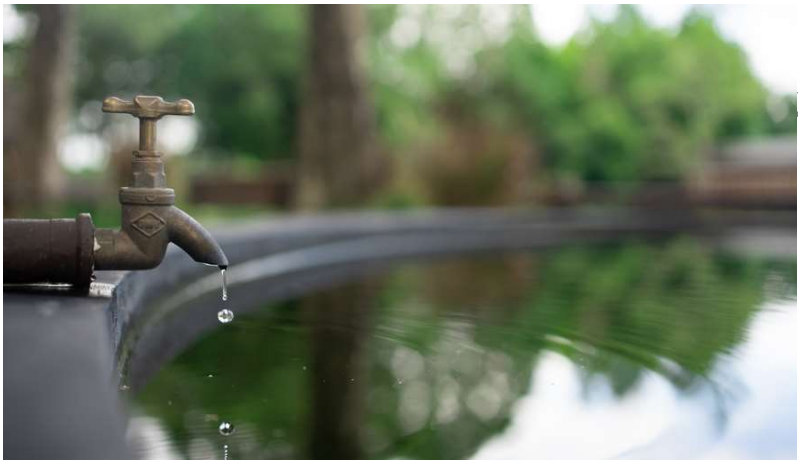

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