

2023 MID-YEAR EQUITY MARKET OUTLOOK

New market regime, a new environment for global equities?

June 2023

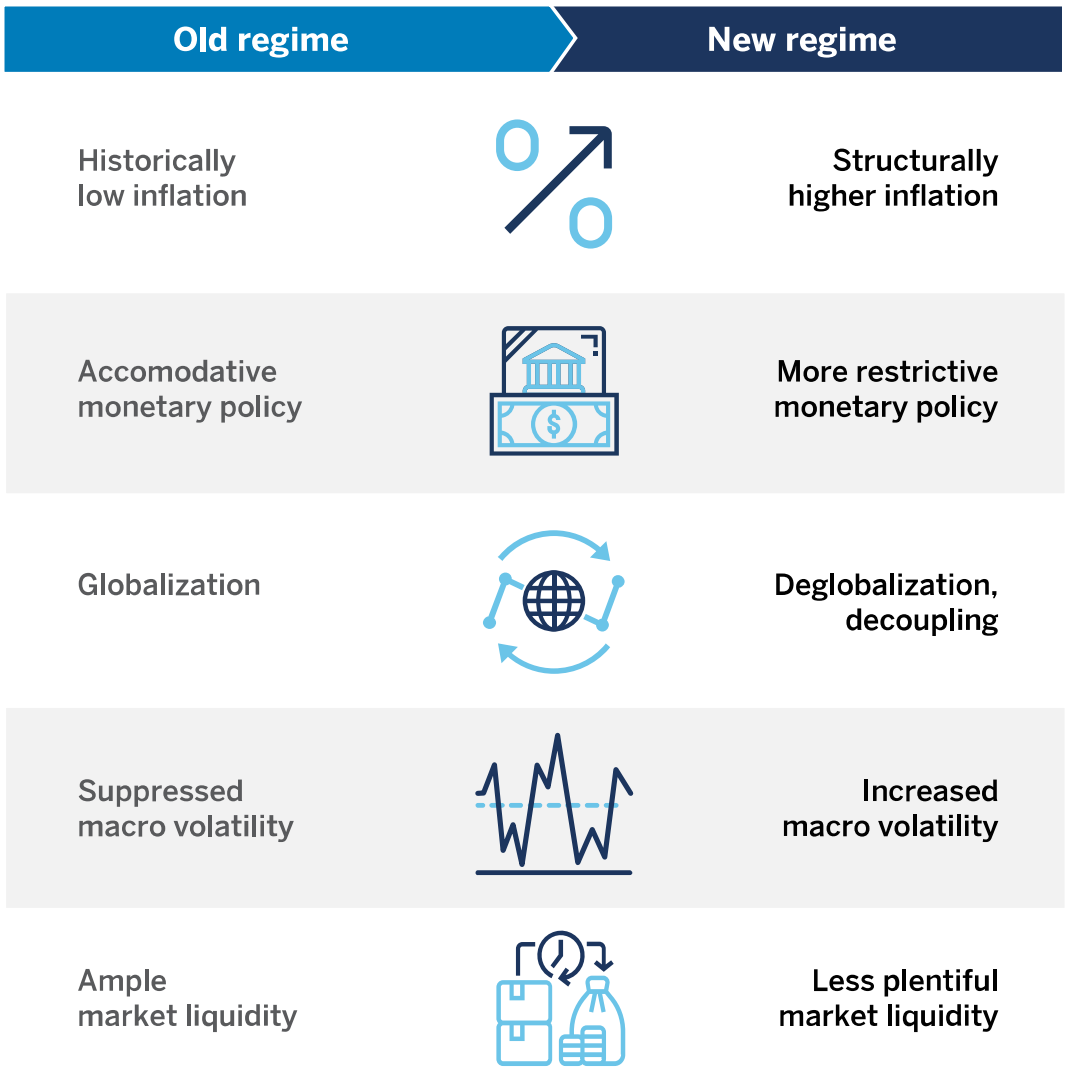


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It's becoming increasingly clear that 2023 is a transition year. Trends that began in 2022, such as rising interest rates and higher inflation, have found firmer footing, coinciding with ongoing geopolitical distress, shifting of the global order, and desynchronized and increased macro volatility. Taken together, these represent a new macroeconomic regime (**Figure 1**).

Figure 1

Characterizing the new market regime



As this new market regime dawns, it's possible that so, too, may a new environment for equities.

Time to shelve the old investment playbook?

It seems unlikely that what has served investors well in the past will continue to do so in today's (and tomorrow's) new environment. And yet, even as the market regime has begun to shift over the past year, market participants seem anchored to the playbook that they've been using for the past 10-plus years.

Changing an investment mindset is a big psychological undertaking. It's human nature to fall victim to recency and availability bias. At this point in time, most investors, strategists, and policymakers have spent their entire careers in a moderate-growth, low-inflation, low interest-rate regime. This "goldilocks" environment has persisted for about three-quarters of the period since the mid-1990s. The long-standing persistence of the old economic world order only makes it that much harder for market participants to alter their mindset along with the ongoing regime change.

At the same time, while today's market environment represents a departure from what's dominated for the past few decades, it's important to remember that these emerging trends are not entirely new. Triggered by

the pandemic and the resulting policies that accelerated long-building structural trends, such as aging demographics, deglobalization, and decarbonization, the world is now returning to the pre-1995 norm, when economies frequently oscillated between cycles — different stages of growth/recession and inflation/deflation.

Equity investment implications of a regime shift

Returning to an environment of higher nominal rates, greater volatility, and more frequently oscillating and desynchronized economic cycles could impact the equity landscape in several ways:

Increasing country and sector dispersion

Among global central banks, monetary policy dispersion in response to inflation has already made itself visible. Going forward, countries will enter and exit cycle stages at different times, and, as a result, for the rest of this year and beyond, risk mitigation and global diversification among equities could be more critical than they've been in the post global financial crisis period.

More volatility in fundamentals and asset prices

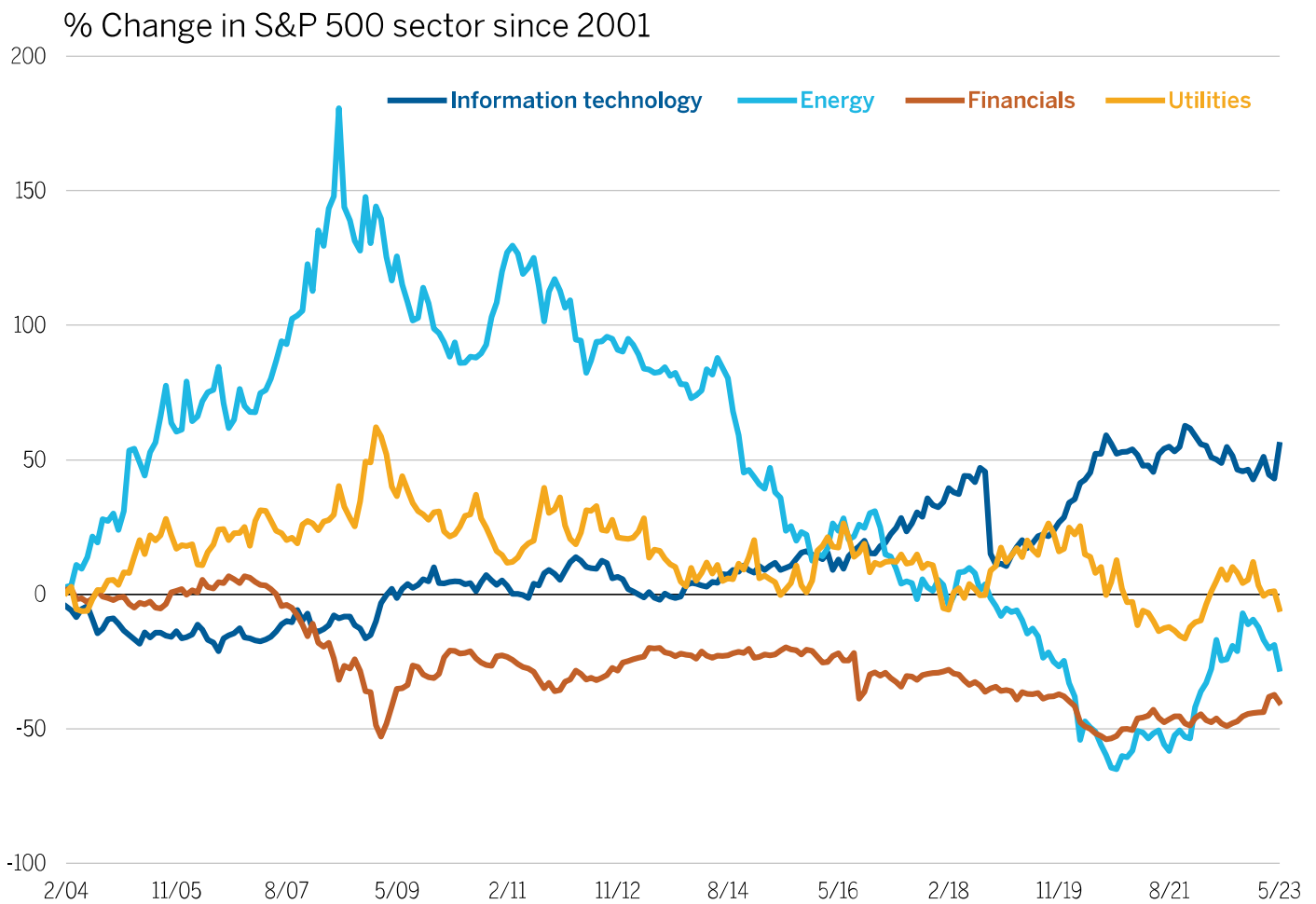
Normalized valuations could go lower, particularly among “long-duration” equities. Going forward, with higher interest rates and increased volatility in fundamentals and asset prices, we expect to see greater demand for relatively stable assets, and the return of more frequent, less synchronized market cycles across regions. Higher volatility and greater cycle dispersion also open the door to opportunistic, thematic, and macro investing — areas of the market that struggled in the prior environment.

Market breadth to expand beyond top tech stocks

For years, a small number of technology companies have driven an outsized proportion of outperformance in the S&P 500 Index, a proxy for the broader US equity market. Today, the information technology sector easily represents the highest percentage of the index (**Figure 2**).

Figure 2

Historical sector weights



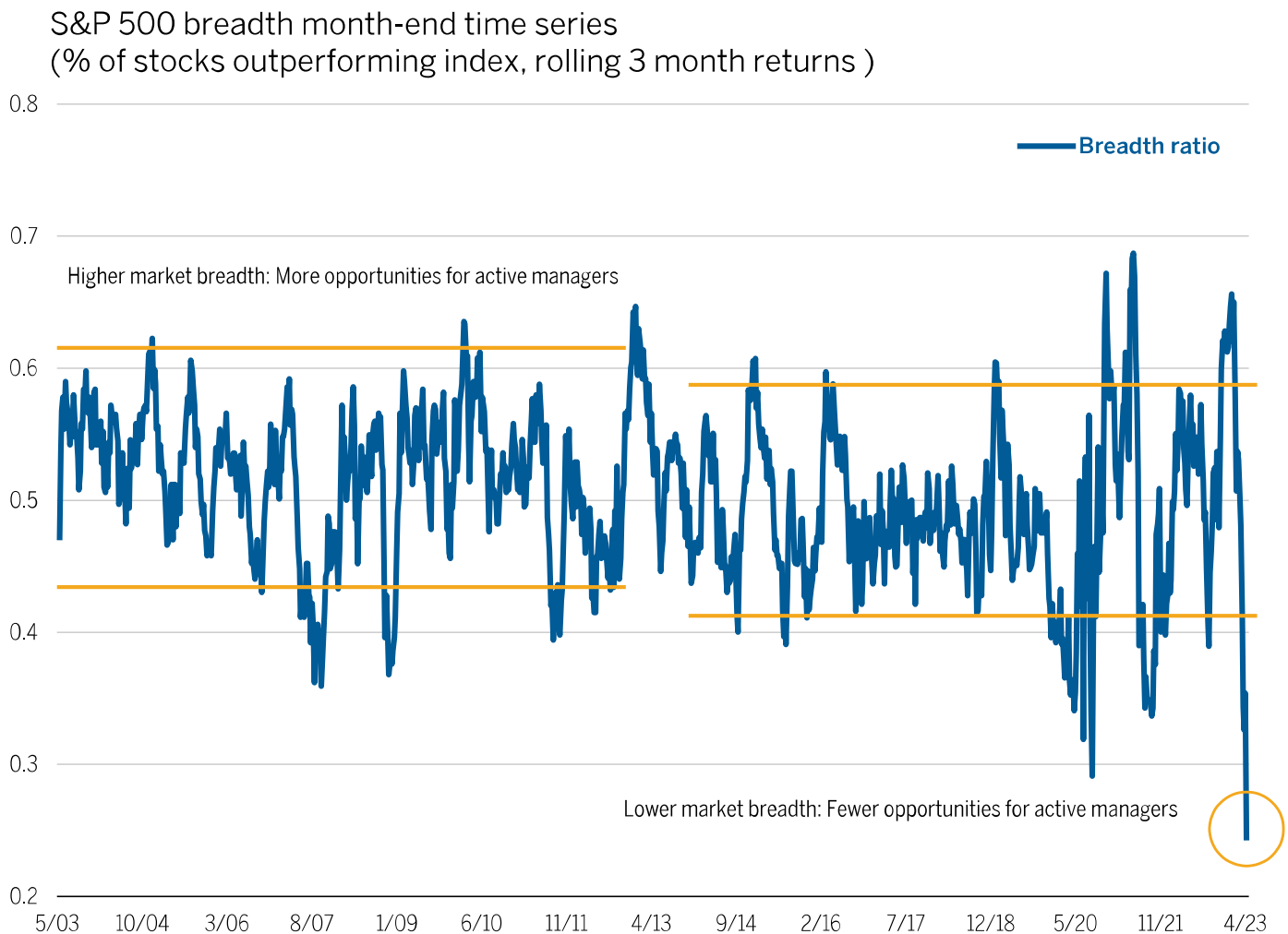
Sources: Wellington, MSCI, Standard and Poor's. The change in sector weights is calculated monthly and reflects the percentage change from the base data of 1 February 2001. | Chart data: Feb 2004 – May 2023

Along with this, US market breadth has hit an all-time low. In fact, at the time of writing,¹ the top-five constituents of the S&P 500 Index — Apple, Microsoft, Alphabet (Google), Amazon, and Nvidia — represent more than 20% of the index, up from 5% in early 2010. Today, Apple alone represents 7.5% of the S&P 500 Index. By many measures, the US market has never been more concentrated.

As the market regime transition continues and investors adapt, markets may begin to favor value, income, and downside-protection-oriented equities, as well as low-correlation diversifiers, speaking to opportunities outside of the handful of tech-sector equities that have reigned supreme for the past several years. Wider market breadth could also reinforce the case for the return of active equity outperformance, as these conditions lend themselves better to active management than the concentrated, narrow market breadth we've witnessed of late (**Figure 3**).

Figure 3

Higher market breadth creates opportunities for active managers



Source: Refinitiv Datastream | Chart data: 17 May 2003 – 15 April 2023

The end of the “golden age” of passive investing...

For much of the past decade, passive equity strategies have outperformed active. The dominance of those select tech top performers has been the primary driver, pushing performance of market-cap weighted indices well ahead of equity-weighted indices. What's more, there have been significant FX headwinds given the strength of the US dollar, underperformance of non-US equities, and underperformance in small-cap stocks. And certain long-duration assets have increased in value because of distortions from sustained ultra-low interest rates, which persisted from the days of the GFC through March 2022. All these have been headwinds for active management.

The bottom line is that the combination of low interest rates, low volatility, and low dispersion has equaled low alpha in active equities, creating the best period for passive equity in US history. However, historically, passive and active equities have traded cycles of outperformance. After a decade-plus run in passive, it may be time to ask: Will the current cycle of passive strength shift with this new regime?

...And the return of active?

Historically, passive and active equities have traded cycles of outperformance. The current cycle of passive equity outperformance is more than 10 years old — even without all the factors outlined above at play, one might wonder whether it's time for the tides to turn in favor of active.

In the old market regime, quantitative easing was a headwind for active equity performance compared to passive. Now, it's possible that the new macroeconomic regime may be more conducive to active equity outperformance. Alpha tends to be highest in environments of higher interest rates, high equity dispersion, and low equity correlation. This is the environment that I believe we'll be in for the foreseeable future, possibly signaling the oncoming return of active-equity outperformance.

Key takeaways for equities

The bottom line is that the market regime began shifting last year and continues today. The old playbook isn't guaranteed to work in a new economic era, and prudent investors ought to prepare themselves for greater volatility, more frequent market cycles, higher inflation, and more going forward. As we move further away from the “goldilocks” environment that we enjoyed for so many years, it will be critical for investors, no matter how difficult, to rethink their approach to markets, but I'm optimistic that opportunities could lie ahead for those who can.

¹As of 6 June 2023.

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