Global Endowment Management

GEM 2023 Market Outlook

Looking Beyond '23

It's that time of the year when seers, prophets, and other prognosticators assess what may be in store for financial markets. 2022 was a brutal year for that group, as the consensus expected stocks to rise, inflation to fall, and the Fed to hike interest rates only a few times. Instead, stocks fell around 20%, inflation hit 40-year highs, and the Fed hiked rates at the fastest pace in history.

As ever, the range of outcomes for 2023 is wide. Rather than attempt to precisely forecast growth, interest rates, and equity prices—or, as Jason Zweig wrote in *The Devil's Financial Dictionary,* "predict the unknowable by measuring the irrelevant"—we use this time to develop a framework for what to expect that incorporates key variables and the possible paths for the global economy.

Our framework identifies **three primary portfolio implications** for navigating a new market environment:

1. Balanced Asset Allocation

Balanced asset allocation will be critical. The era of simple stock/bond diversification is likely over.

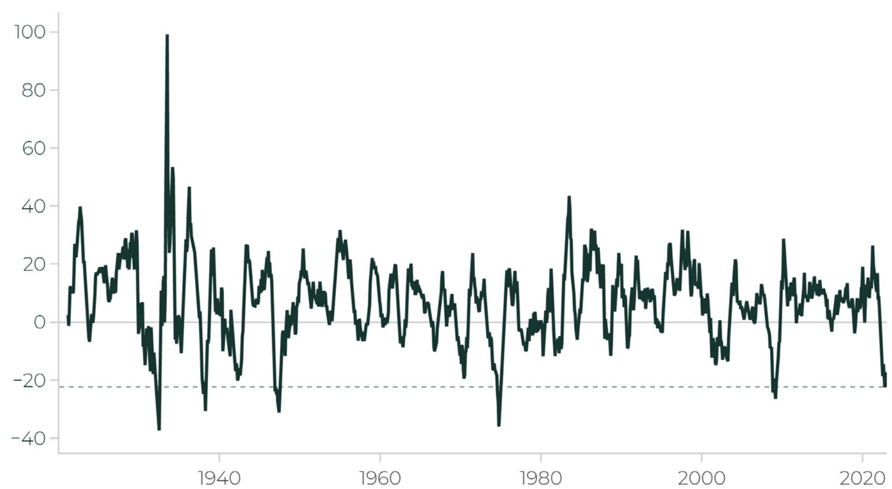
2. Higher Real Assets Correlation

Commodity demand, US dollar weakness, and pressure on long-duration sectors will shift investor focus toward emerging markets and other market segments with higher real asset correlation.

3. Strong Governance & Risk Management

More inflation and geopolitical volatility will put a premium on a dynamic approach to risk management and strong governance norms.

US 60/40 Real Return (bps, 12 months)



Source: Bloomberg and GEM analysis. US 60/40 Real Return is 60% S&P 500 and 40% Bloomberg Barclays US Aggregate Index.

Chief among those key variables is inflation. 2022's unexpected acceleration in inflation caused the worst year for bonds on record, and led to real return losses for a 60% stock/ 40% bond portfolio comparable only to the GFC, the mid-70s Great Inflation, and the aftermath of World War II. What comes next for inflation will in large part dictate the course of asset prices this year. If the temporary inflationary factors associated with the COVID-19 pandemic recede and inflation returns to "normal," the Fed can end monetary tightening. In that scenario, bond prices and stock valuations are likely to recover. If inflation proves sticky, however, and the Fed is forced to continue rate hikes or hold a restrictive policy stance longer than current expectations imply, the US likely falls into recession, weighing further on risk assets. **We believe probabilities favor a US recession.**

But in honor of just how badly Wall Street forecasters were caught off guard by what transpired in 2022, we're casting our gaze further out, beyond 2023.

The more interesting question for investors is now: To what extent will inflation change the investment landscape over the longer term?

A History of Disinflation: A Series of Fortunate Events

In its self-written history, the Fed describes the low and stable inflationary period between 1982 and 2007 as the "Great Moderation." Never mind that the episode ended with a calamitous asset bubble that the Fed inflated to offset the implosion of the *previous* asset bubble in the late 1990s. When assigning credit for the halcyon days of steadily declining long-term yields, the Kansas City Fed is unequivocal: "Better monetary policy was key."[1]

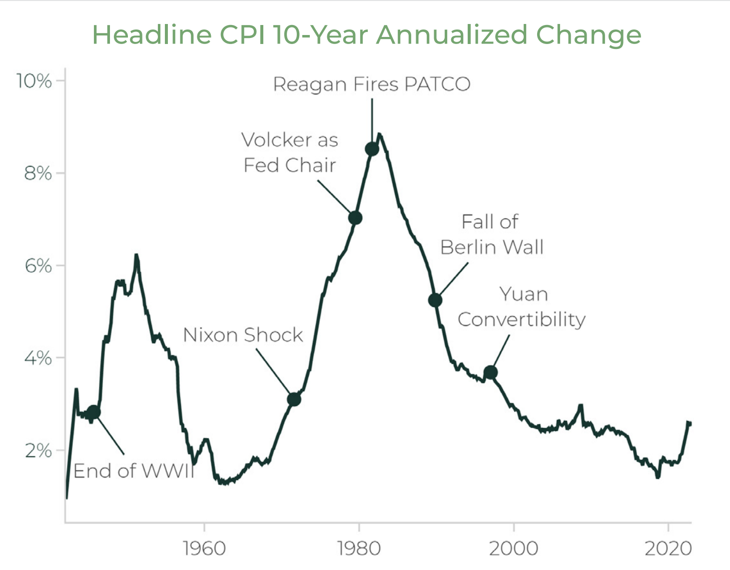
Monetary policy was essential to tame the runaway inflation of the 1970s. However, the 25-year period of disinflation that began with Paul Volcker's double-dip recession was driven by much more than the Fed's experimentation with monetarism:

1. Capital vs Labor.

Labor's bargaining power over capital suffered a steady erosion. In 1981, PATCO became the first federal union to ever be decertified after President Reagan busted a strike by the air traffic controllers.[2] In the subsequent 38 years through 2021, the number of wage- and salary-employed in the US grew by more than 48 million workers while union jobs declined by nearly four million.[3] During that time labor compensation declined relative to GDP, while the share of the economy going to corporate profits more than doubled.

2. A Global Workforce.

After the fall of the Berlin Wall, the return of the Soviet Republic and its satellite states to the global trading system added over 200 million people to the working age population by the end of the 1990s. This constituted a supply-side shock that expanded the labor pool, raised living standards in Eastern Europe, and depressed wages globally. It also contributed to China's focus on raising the living standards of its citizens.



Source: Bloomberg and GEM analysis.

3. Supply Chain Optimization.

The Japanese asset bubble of the late 1980s came with plenty of anecdotes on the perils of exuberance. But the other lessons from the rise of Japan Inc. related to production efficiency. Kaizen, "lean" production, process optimization, and just-in-time inventory management had some votaries among US industrial firms at the time, but the concepts became business school and corporate theology. The effect was longer supply chains and increased profitability.

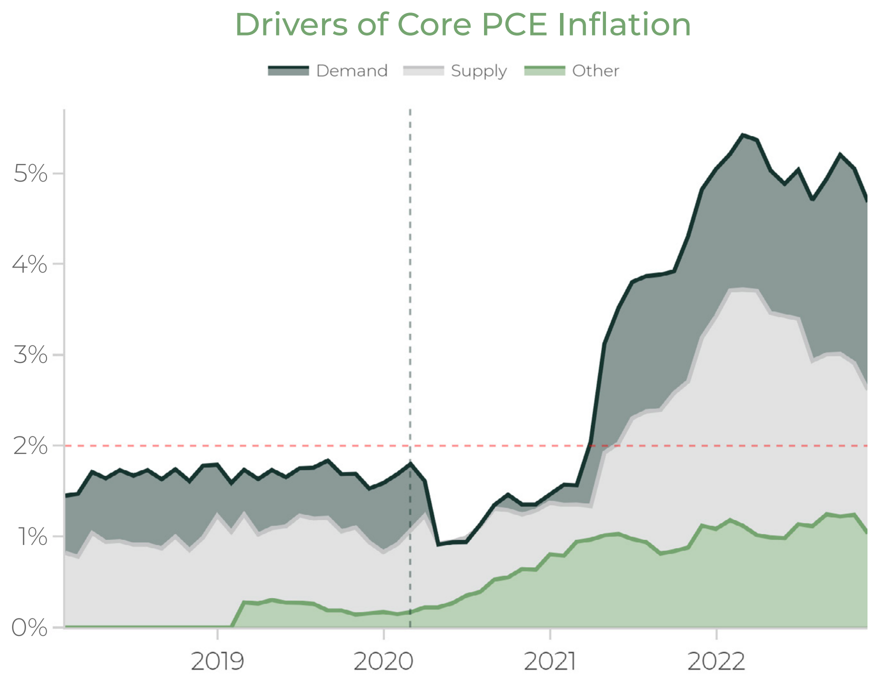
There were other supportive factors too, but the point is that **low and stable inflation for over two decades was due to the combination of good policy and several happy accidents.** Although Alan Greenspan and Ben Bernanke stood on the shoulders of a true giant (and yes, that's a height joke), they also benefited immensely from a tailwind of post-Cold War geopolitical re-sorting that elevated economic prosperity over hegemonic rivalry. If the low inflation environment had significant secular drivers, then an assessment of inflation's future must consider whether those drivers will persist or reverse. The unique circumstances of the Covid era, however, complicate the picture.

The Covid Era: Twin Shocks of Pandemic and Policy

Entering 2020, Wall Street consensus expected the global manufacturing slowdown to end, inflation to remain tame, and the Federal Reserve to hold short-term rates steady after three cuts in 2019. Most investors were cautiously optimistic on stocks. Of course, Covid upended everyone's expectations, causing the fastest economic contraction on record and the largest since the Great Depression.

Initial Covid lockdowns destroyed demand, and the global policy response to offset the impacts was substantial, particularly in the United States. We anticipated the increased use of fiscal tools in 2020 to stimulate moribund economies, with policies up to and including Modern Monetary Theory (MMT), and then Covid encouraged their deployment. Developed world governments ramped up both fiscal and monetary accommodation, creating MMT by another name.

Because the demand destruction was by edict, it wasn't responsive to low interest rates or fiscal transfers in the conventional way. Demand-side inflation only rebounded after the roll out of vaccines, and shortly thereafter reached its highest level in the more than 20-year history of the Fed's data. On the supply-side too, snarled global supply chains, Covid-related business disruptions, and labor shortages ultimately led to more inflation in late 2021 that was sufficient to exceed the Fed's 2% target all on its own.



Source: Federal Reserve Bank of San Francisco.

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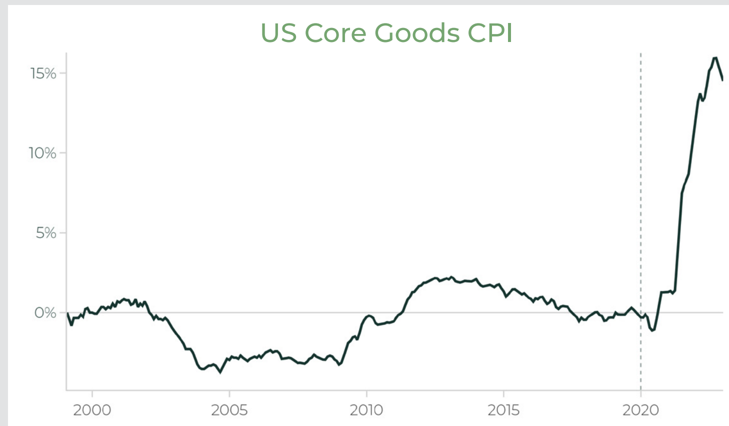
While government policies were successful in curtailing what could have become a sustained depression following economic lockdowns, their consequence was an obvious inflationary impulse. That artificial increase in income without corresponding production expressed in **three primary forms**:

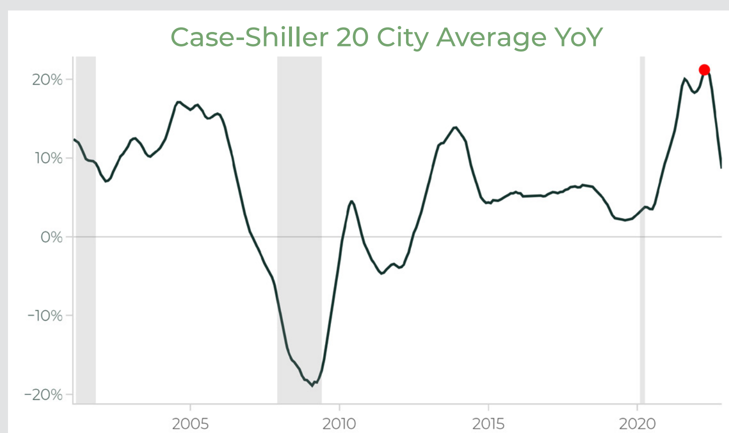
1. Historic **goods inflation.** During the twenty years ended 2019, core goods prices in the US declined. Over the ensuing 33 months, core goods inflation reached 5.6% annualized, the highest since 1983.



Source: Bloomberg and GEM analysis.

2. The inflation of several **asset bubbles,** particularly meme stocks and crypto assets. According to Charles Schwab, 15% of retail investors in the US invested in the stock market for the first time in 2020, and Bloomberg estimated that retail accounted for nearly 20% of all shares traded during the first six months of 2020 (over four times the level in 2019). Government stimulus, new accessible technology, and lockdown-induced boredom combined to create a boom in retail trading that flamed exuberance.

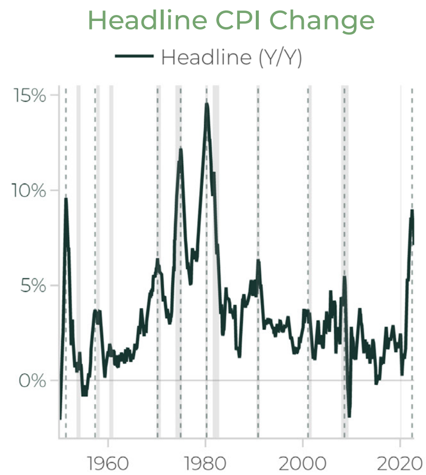
3. **Soaring home prices,** low interest rates, ample cash for down payments, and new attitudes around work-from-home also lit a fire under the housing sector. The Case-Shiller 20-City Composite Index peaked at over 21% YoY in April, a delayed reaction from 2020's boom that saw housing supply fall to three months at one point, the lowest on record.

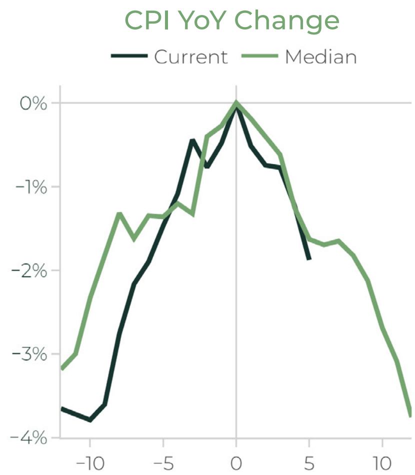


Source: S&P Case-Shiller.

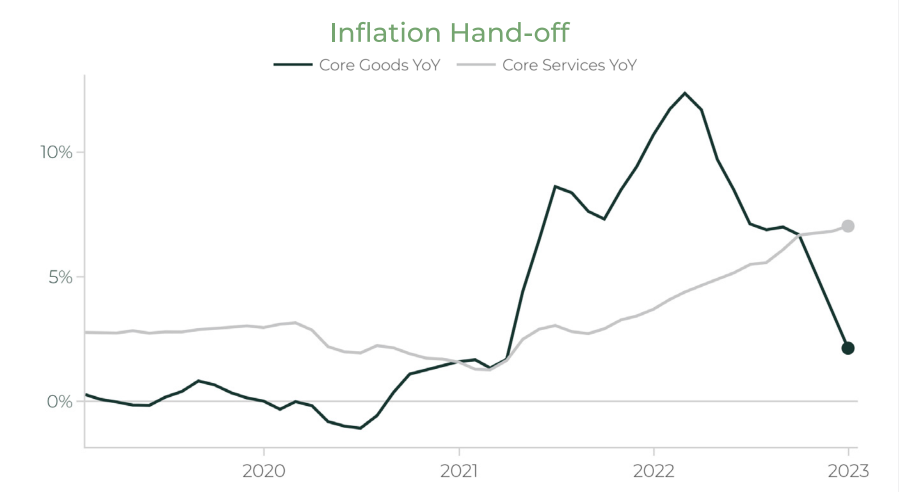
Transitory, Structural, or Secular: What's Left?

How much of those inflationary impulses are transitory and pandemic-related, and how much are due to the structural headwinds which require untangling? Although Chair Powell famously retired the word "transitory" a year ago—as both market pricing (of inflation swaps) and the Wall Street consensus undershot headline CPI—2022 ended with two good inflation reports in the US. Both indicated a normalization since the June peak in headline inflation that tracks closely with historical disinflationary analogs. Current housing activity suggests rent inflation will eventually cool, and there's been a rapid easing in supply constraints, which some prior Fed surveys suggested would not happen before 2023 at the earliest. In other words, inflation is receding as you might expect after such a pronounced shock.



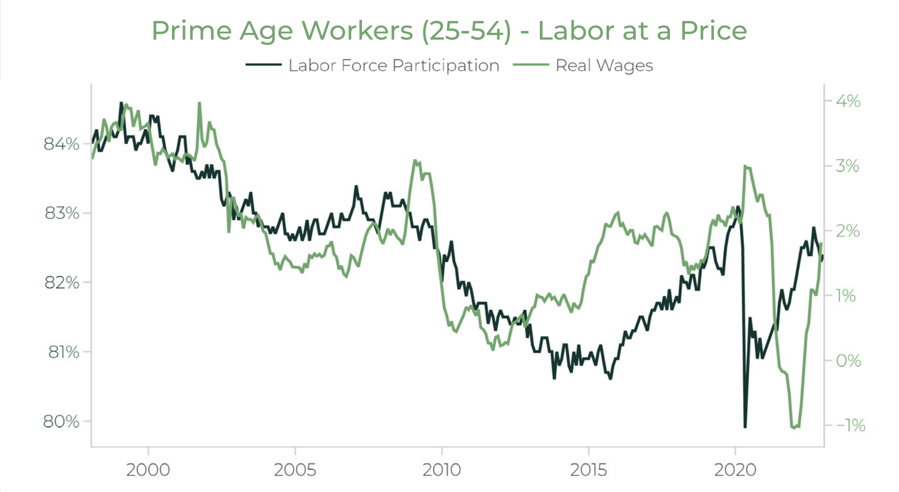


Source: Federal Reserve Bank of St. Louis and GEM analysis.



Source: Federal Reserve Bank of St. Louis and GEM analysis.

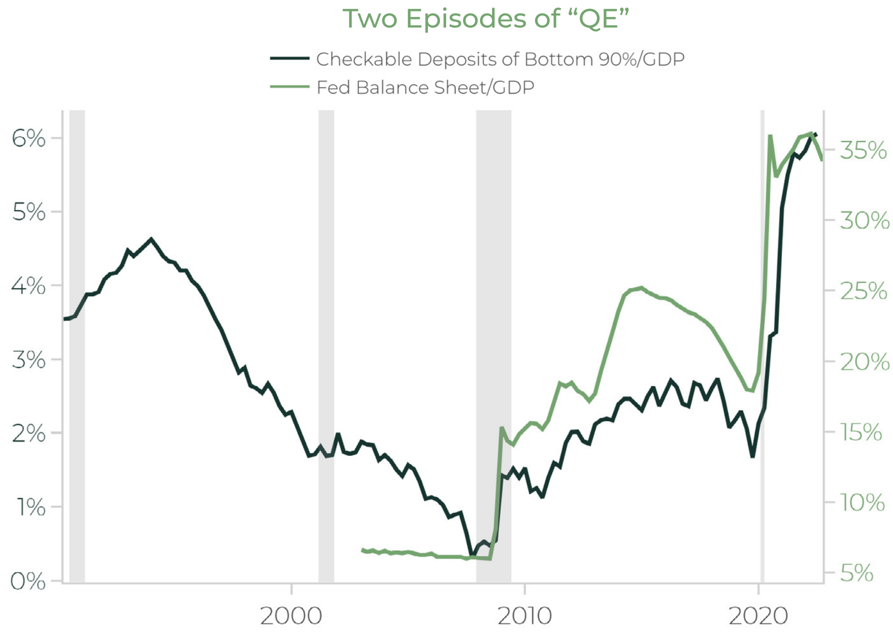
However, beginning in 2021 we warned that those supposed transitory factors could last long enough for a hand-off to persistent forms of inflation, like wages.



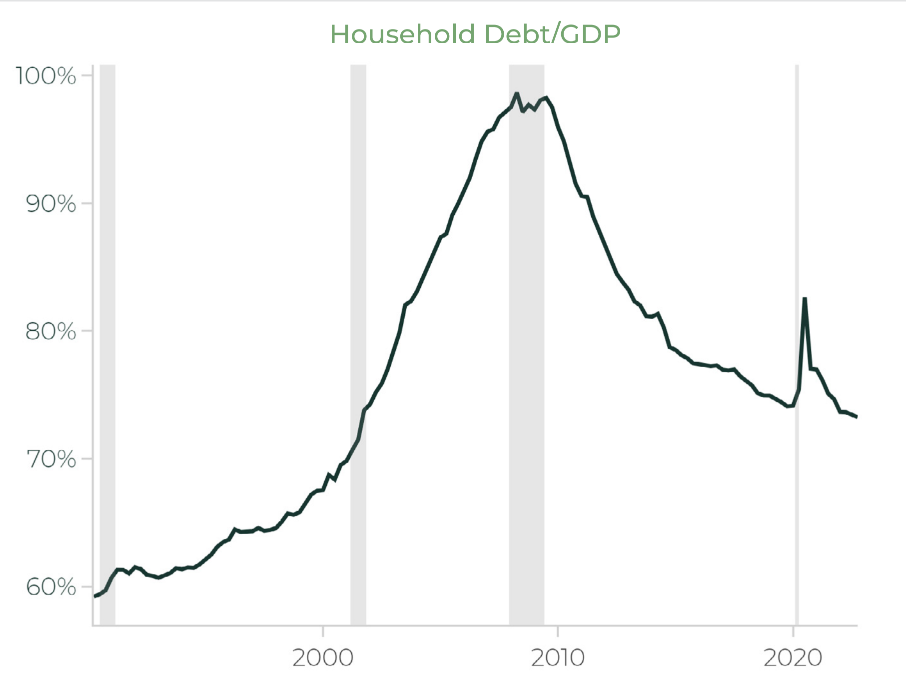
Source: Federal Reserve Bank of St. Louis and GEM analysis.

In some respects, it appears that prediction has come to pass. The labor market remains red hot. Looking only at the prime age employment-population ratio (which removes the effect of aging), the portion of people working has been trending down for two decades. In fact, the ratio has yet to recover to its pre-Covid peak. It will take higher wages to lure those workers back.

Moreover, the Fed is faced with the consequences of what Ben Bernanke once labeled "helicopter money." The Fed's GFC-era quantitative easing resulted in an increase in excess bank reserves as deleveraging dominated any impetus to take on more debt. That supported asset prices, but not consumer spending, and hence had little impact on inflation. The Covid money-drop—directly sending cash to consumers—was far different because it circumvented the banking system. From the GFC through 2015, the Fed expanded its balance sheet by the equivalent of ~20% of GDP. During that time checkable deposits for the bottom 90% of Americans (based on net worth) increased by 2%. During Covid, the Fed's balance sheet grew by ~20% of GDP again, but cash balances for the bottom 90% increased by over twice as much, to a historic 6% of GDP.



Source: Federal Reserve Bank of St. Louis and GEM analysis.



Source: Federal Reserve Bank of St. Louis and GEM analysis.

The conundrum for the Fed is that this accumulated savings may be less sensitive to changes in financial conditions. Said another way, the Fed can't extinguish it. In the past, the Fed weighed on credit conditions with higher interest rates, which reduced consumers' ability to borrow (and spend). Curbing excess demand may require job losses that divert excess savings to make up for lost income, or declines in housing value that hurt spending via wealth effects—i.e., recession. Even the housing mechanism may prove more stubborn than in the past given low turnover from in-place fixed mortgage rates, and the increased ability to work remotely obviating the need to move.

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All told, some of the pandemic's inflationary anomalies are receding. But some structural elements remain. As a result, a prompt return to the Fed's 2% target seems unlikely. **Moreover, many of the other secular disinflationary tailwinds that led to the Great Moderation era also continue to reverse:**

1. The loss of cheap labor overseas is exacerbated by aging populations. Countries with a higher proportion of prime-age workers tend to be disinflationary as they save to support future spending. Several large economies are projected to see decreases in their prime-age population of between 20% and 30% through 2050. As developed economies see growth in consumers relative to savers, that trend will exert upward pressure on inflation (and interest rates).
2. As a share of global GDP, trade peaked with the GFC and its recovery was stunted by the last administration's trade war. Trade will remain important to global economies, but the weakening of these ties reverses disinflationary tailwinds that have helped keep inflation down for decades. Deglobalization means higher prices.
3. The post-Covid focus on more robust supply chains should also contribute to higher inflation. Long and complicated supply chains were created to optimize around costs, so shortening and simplifying them will be inflationary.

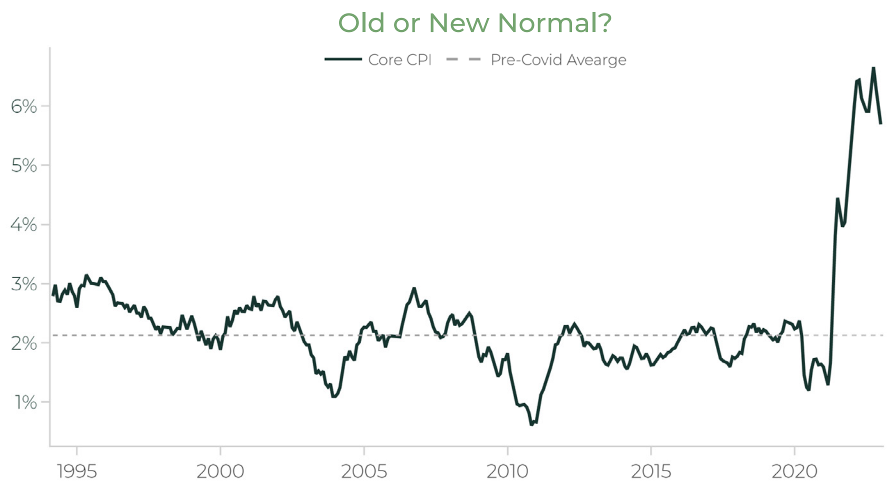
A combination of inflationary forces —receding transitory forces, persistent structural forces, and steady secular forces —will likely cause inflation to settle higher than the Fed's current 2% target.

A New Era: Portfolio Implications

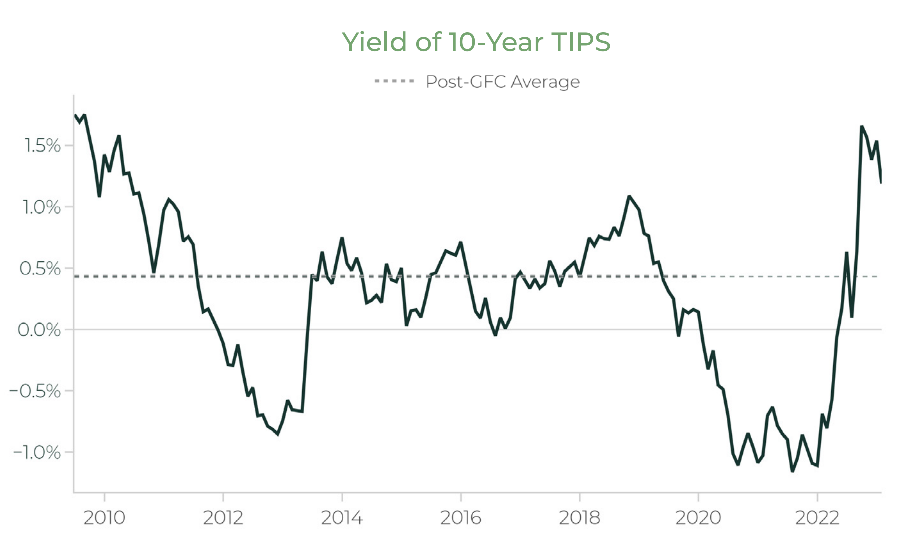
A world of less cooperation and more conflict, with a shift from capital to aging labor, and with higher interest rates and inflation, creates a more challenging environment for capital deployment. It requires a new investor playbook, with important implications for investment policy, strategy, and tactics.

INVESTMENT POLICY IMPLICATIONS

In investment policy, the zero interest rate-era was not kind to diversified portfolios. The more complex the asset allocation, the less well it fared relative to a simple stock/bond mix. However, it's no longer appropriate to think of stock/bond portfolios as sufficient. **We believe the recent outperformance of truly diversified portfolios—i.e., those with exposure to distinct risk factors like commodities and real estate—will persist** in an environment where inflation is sticky.



Source: Federal Reserve Bank of St. Louis and GEM analysis.



Source: Bloomberg & GEM analysis.

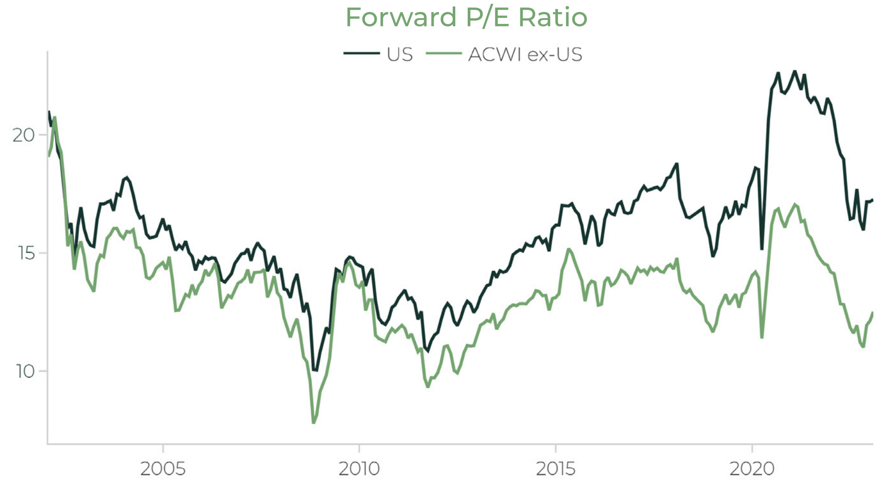
The good news is that a world where interest rates are more market-driven improves forward looking returns. As "There Is No Alternative" (TINA) yields to "There Are Reasonable Alternatives" (TARA), much of the bond market becomes investable again as real yields turn positive. From the end of the GFC through 2019, real yields for US Treasuries averaged just 0.4%, versus 1.5% now. Investment-grade bonds in the US recently exceed a 6% yield, their highest since the GFC. Institutions seeking a 5% real return on portfolios can now achieve their goal with less expected volatility, which enables more conservative investment policies.

The good news:

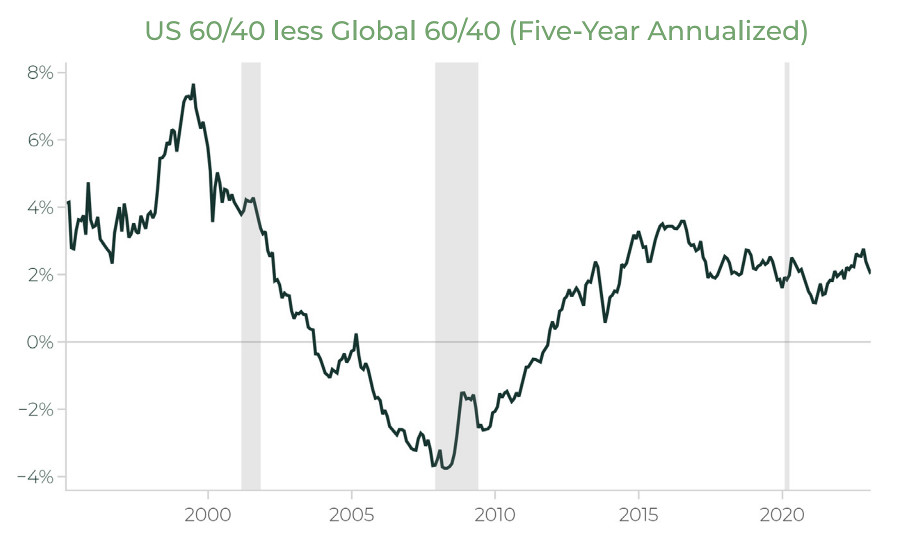
Positive real interest rates mean improved forward-looking returns.

INVESTMENT STRATEGY IMPLICATIONS

At a strategic level, US stocks have been the “cleanest dirty shirt” in a low-growth world, afforded a healthy valuation premium. The massive increase in the market cap of information technology stocks has helped, but in the ten years before the onset of Covid, S&P 500 earnings growth (even excluding tech) exceeded 9%. Rock-bottom global interest rates bolstered the valuations for long-duration stocks, which benefitted the US disproportionately.



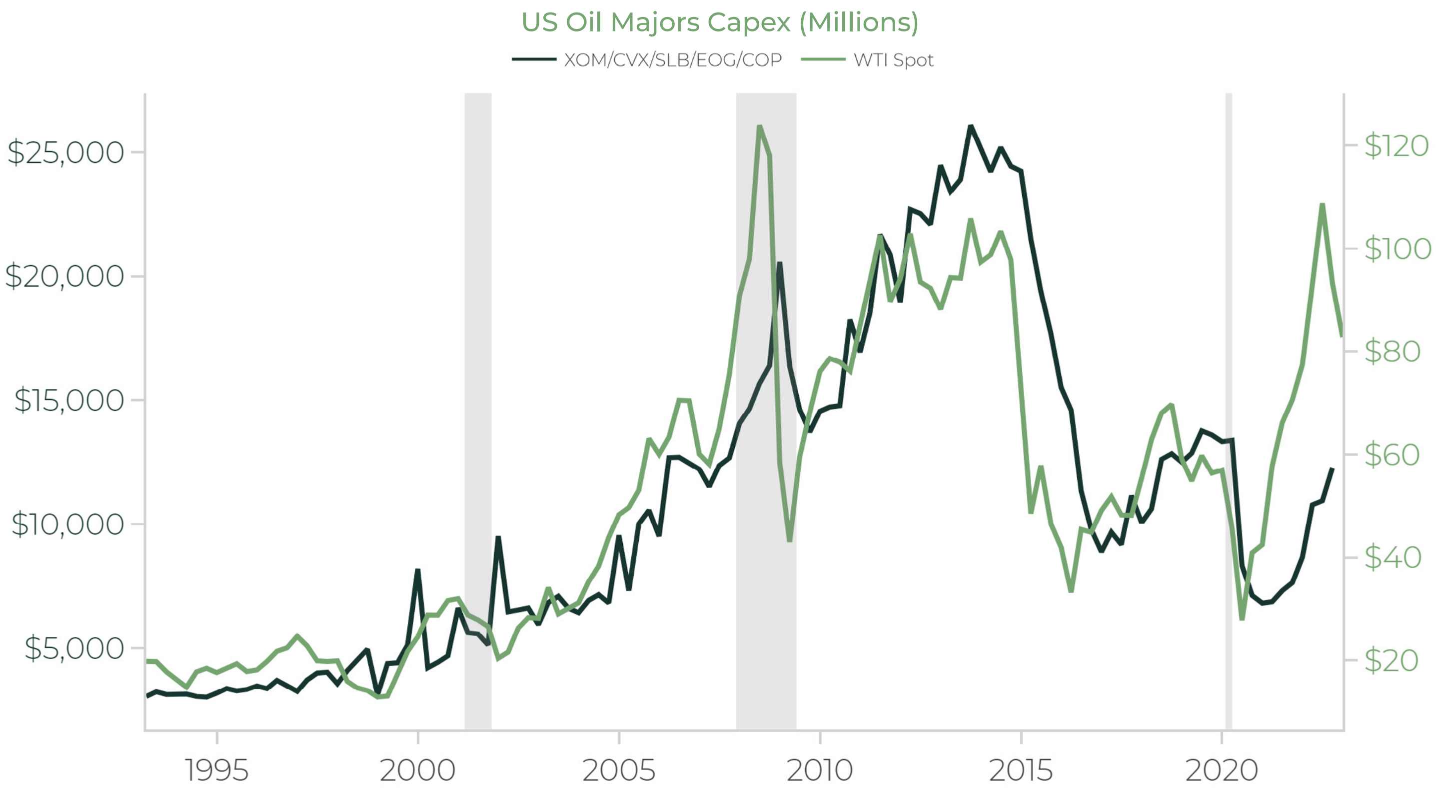
Source: MSCI.



Bloomberg and GEM analysis.

In the future, high nominal growth and interest rates globally should lead to more convergence in equity market valuation, particularly with the bloom off the tech rose. That trend favors non-US markets, which also tend to have more exposure to old-economy sectors that would benefit from structurally higher inflation. The US dollar recently reached levels of overvaluation that have only happened once in post-Bretton Woods era. A correction in the dollar will provide a further tailwind to overseas assets.

Amid inflation and war, commodities had a torrid start to the year. China's Zero Covid policy and global inflation fears caused a sharp correction, but commodities remain the best performing asset for 2022, and the only one with positive returns. Commodities are priced at the margin, and any slowdown in aggregate demand will hurt the asset class. However, commodities are in a far different position than during the last two recessions. Before 2020's total economic shutdown, the GFC saw a balance sheet deleveraging following an investment boom in commodities. As one example, despite spot oil prices reaching 2013 levels, capital expenditures from oil majors are down more than 50% since then. What's more, public companies have been pressured increasingly to redirect spending towards renewables and away from hydrocarbons. Copper—another key material for the energy transition—is expected to see its global per capita consumption double over the next 15 years, and it is in woeful undersupply.[4] In the new normal, **commodities are likely to provide important ballast to diversified portfolios** as capital rotates from financial assets to real assets.



Source: Financial Modeling Prep, Federal Reserve Bank of St. Louis, and GEM analysis.

Lastly, the rising stock/bond correlation puts a premium on finding uncorrelated sources of return. Absolute return strategies—whether market neutral or tied to alternative betas (like reinsurance, royalty streams, or trade claims)—seem poised for a recovery; if not in return potential, than at least in interest from allocators seeking a means of controlling portfolio risk.

TACTICAL IMPLICATIONS

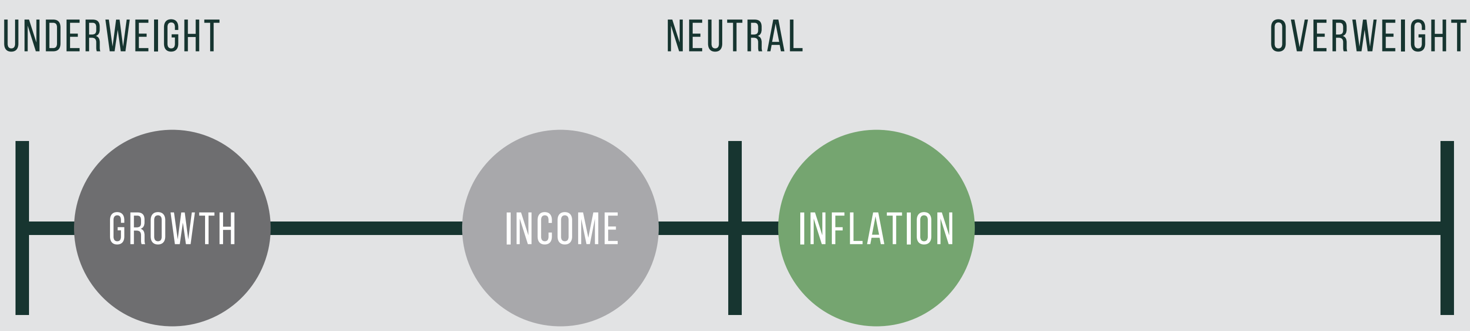
Over tactical horizons, volatility is likely to be consistently higher than it has been. Having a means to manage exposures dynamically—through bouts of market enthusiasm and despair as the relative returns of asset classes swing portfolio weights around—will be crucial. Sourcing cost-effective tail hedges, either on the left or right tail, and finding ways to neutralize a conventional portfolio's short volatility bias, can be additive. That skill is not one many allocators have sought to develop over the last ten years because it's been in little demand, but as the market shifts we expect choppier waters.

In preparation for the chop, committees and boards should prepare themselves for behavioral challenges too. Investment programs are only as effective as the governance norms underpinning them, and more short-term variance around long-term expected returns can encourage impatience and poor decision-making, both of which threaten long-term success. Spending more time discussing goals, horizons for evaluation, and visualizing the possible paths that returns may take —some of which will be painful in the interim—is a useful exercise.

To start 2023, we favor inflation-oriented assets at the expense of growth-oriented assets, with income somewhere in between.

Because earnings are a real asset, equity should be favored over credit. Given relatively low starting discount rates, as well as decades of underinvestment, we favor commodities over REITs. Finally, modest pricing for implied inflation and the higher correlation for Treasuries with stocks leads us to favor TIPS over nominal Treasuries. We also reserve some dry powder in the form of cash.

Factor Views



Conclusions: 2023 and Beyond

The world is changing. And yet, we believe the market is pricing in a *Back to the Future* scenario of low inflation and interest rates with accommodative central banks. Despite protests from officials that they're not pivoting in their policy stance, forward rate markets have priced Federal Reserve rate cuts in the second half of 2023. We believe that's wishful thinking.

An environment of higher inflation and interest rates is not a sufficient condition for true capital market distress, but will be a headwind to asset prices until markets adjust to the new reality. The higher stock/bond correlation associated with increased and more volatile inflation makes the balance of a broadly diversified, endowment-style portfolio more important.

Over horizons relevant to perpetual investors, however, and no matter what the Wall Street annual outlooks tell you, it is the seismic shifts in market environments and regimes that matter. They turn the economic and psychological Rubik's Cube on its side, presenting opportunities and challenges in a new light. Although the world will inevitably evolve in ways we don't expect, we believe 2022 represented the beginning of such a shift. It was an important transition in market leadership: a step toward a new set of conditions.

About Global Endowment Management

Global Endowment Management (GEM) is a leading Outsourced Chief Investment Office (OCIO) providing institutional investment capabilities for endowments, foundations, and other long-term investors. For over fifteen years GEM has stewarded the financial assets of our clients to enable them to fulfill their missions. GEM's history is deeply rooted in endowment-style investing, with today's approach modernized to offer custom solutions tailored to each client's unique investment needs. For more information visit www.globalendowment.com.

Endnotes

[1] Hakkio, Craig S. "The Great Moderation." Federal Reserve History. https://www.federalreservehistory.org/essays/great-moderation.

[2] "The 1981 Patco Strike." University of Texas at Arlington Libraries. https://libraries.uta.edu/news-events/blog/1981-patco-strike.

[3] "Union Membership Rate Declines in 2021, Returns to 2019 Rate of 10.3 Percent." U.S. Bureau of Labor Statistics. https://www.bls.gov/opub/ted/2022/union-membership-rate-declines-in-2021-returns-to-2019-rate-of-10-3-percent.htm.

[4] "Growing Appetite for Copper Threatens Energy Transition and Climate Goals." S&P Global Market Intelligence, November 11, 2022. https://www.spglobal.com/marketintelligence/en/mi/research-analysis/growing-appetite-copper-threatens-energy-transition-climate.html#:~:text=Copper%20.

Important Notes