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Monthly Letter: Inflections diverge

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Inflection points are being reached at different times in different regions. China and Europe are inflecting sooner than expected. But the jury is still out on whether the US economy is headed for a hard or a soft landing. In our new Monthly Letter, we look at how investors should position as inflections diverge.

The jury is still out on whether the US economy is headed for a soft or hard landing. Strong job growth and retail sales data suggest it is holding up well against the headwinds from higher interest rates. But equally, the marginal decline in US inflation in January and a still tight labor market suggest that the Federal Reserve will need to increase rates further, perhaps substantially, in order to bring inflation back to target.

Caught between these divergent potential outcomes, equity markets have been left trading well above October's lows while also lacking the conviction to move materially higher.

In our *Year Ahead 2023*, we said that this would be a year of inflections, in which economic growth would first slow before reaccelerating around the middle of the year. At a global level, we think this view remains intact, but the latest data suggest it is happening at different times in different regions.

China and Europe's economies are inflecting sooner than expected. By contrast, the resilience of the US economy is perhaps raising the risk of a later, deeper recession there, resulting in a more prolonged period of uncertainty.

These divergences mean we think investors should take a more regionally selective approach to their risk decisions, rather than making blanket "risk-on" or "risk-off" calls. Our positioning reflects this. We like select relative value opportunities that should help investors position for inflections across the global markets, but also reduce downside risks.

Tactically, we think the current environment means investors should ensure they diversify beyond the US and growth stocks:

First, faster inflection points in Europe and China affirm our view that emerging market equities, as well as select parts of the European market, including Germany, will perform better than US equities.

Second, inflation and interest rate uncertainty means we continue to believe value stocks#including the global energy sector#will outperform growth stocks.

Third, considering the downside risks to the US economy, we continue to advocate maintaining some defensive exposure, although among defensive sectors we now see greater opportunity in consumer staples than in healthcare.

Elsewhere, given elevated yields, we see a variety of opportunities across the fixed income spectrum, including in high grade, investment grade, and emerging market bonds. However, we remain cautious on high yield corporate credit.

We expect broad commodity indexes to move higher given constrained supply and strong demand. Commodities should benefit from China's reopening, and we think the asset class is also a good hedge against the risk of more persistent inflation.

Lastly, we think less correlated hedge fund strategies can play an important role in portfolios as we navigate correlated markets still driven by expectations for central bank policy.

Read more in our latest Monthly Letter, "Inflections diverge," and watch a short video on the main themes here.

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