2023 Outlook: Return To and Returns From Active Management

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Active management benefited from the regime shift that began in 2022, and we believe this environment will continue for the next several years. We feel fundamental dispersion will remain elevated, driving a return to and returns from active management.

Backdrop

Beginning in 2020, we began to see a reversal of the longstanding regime of globalization. Globalization meant that the developed world was able to outsource the production of goods to emerging markets. The trend was deflationary, as developed markets imported low-cost labor while supply chains became more efficient. The resulting deflationary forces drove low levels of economic volatility and low inflation, enabling policymakers to not only keep interest rates low, but to also use accommodative policies without the threat of inflation.

We are now in a period of deglobalization, a phenomenon that has opposing forces to those outlined above. Globalization requires economic and geopolitical stability in order to thrive, but we are in an increasingly multi-polar world which has many implications for economies and markets. If globalization were deflationary, then we feel it is reasonable to expect that deglobalization would be inflationary. As nations look to secure their production of goods, supply of food, and reduce their fossil fuel energy dependence, the cost of labor and inputs is likely to remain elevated.

The reversal of long-term trends will lead to elevated dispersion through increased macro-led opportunities and shifting cross-market correlations. 2022 offered plenty of macro shocks as central bankers reacted to stubbornly high inflation with, in many cases, record paces of rate hikes. These policy decisions created many asymmetric opportunities for active managers to generate profits across all asset classes. We believe that 2023 will be different, as companies, consumers, policymakers, and markets digest these rate hikes. Dispersion across markets was high in 2022 as correlations broke down, but, except for fixed income, volatility levels generally remained subdued. These factors led to a year of strong trends. We believe 2023 to be more volatile with higher rewards for idiosyncratic risk taking. If 2022 was the year of macro-led dispersion, we believe 2023 to be more about micro-led dispersion.

Below is our summary of what we think will be the key drivers of trends and dispersion across the major asset classes.

Fixed Income

Duration risk drove markets in 2022, as central bankers hiked rates at record paces to fight inflation. Although credit spreads widened over the course of the year, corporates had largely refinanced their debt over the last several years and locked in low financing costs, therefore leading to very little stress for corporate bonds. We believe that U.S. Treasury yields will drop through 2023 as markets price in lower inflation levels and the expectation of future rate cuts. For credit, however, we anticipate seeing much higher levels of dispersion and, therefore, an excellent trading environment.

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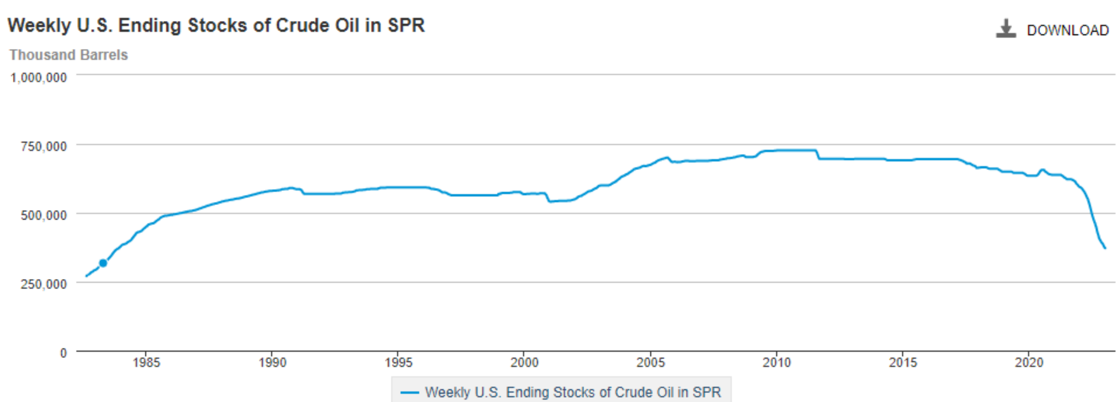
Low interest rates and tight credit spreads had allowed corporates to keep their interest expense muted since 2009. In the current interest rate environment, however, CFOs are faced with choices and challenges on keeping companies' interest expense manageable. Floating rate debt, such as corporate loans, are at the most expensive part of the yield curve, while longer term bond refinancing will be at materially higher rates than existing debt. Private equity sponsors have driven material issuance in the loan market over the last 10 years, adding to the CLO supply. Rising costs of this floating rate debt alongside weaker fundamentals will challenge many private equity sponsors. Many of these groups sit on large cash balances, but they will likely need to choose between their different holdings, supporting some while others will experience distress. These decisions should catalyze increased dispersion across credit markets. In addition, they will likely lead to a new dynamic of distress in the rapidly growing private middle markets. We believe this environment will offer significant event driven opportunities around debt capital markets both in the U.S. and in Europe. We also anticipate seeing higher issuance of convertible bonds as companies focus on ways to reduce their coupon payments.

Commodities

2022 was a year of two halves for commodity markets. The first half was more a story about supply constraints, many of which were accelerated by the war in Ukraine. During the second half, markets appeared more focused on demand and the implications of a growth slowdown. We expect to see a similar backdrop in 2023, with commodity markets narratives rotating between undersupply and weakening demand. From a longer-term perspective, however, we believe the supply side is far more of a constraining factor and will lead to a multi-year trend higher across commodity markets.

On the demand side, we also see a few factors that could cause both short – and long – term upside to commodity markets.

1. The United States Department of Energy has been releasing oil into the U.S. economy through the Strategic Petroleum Reserves ("SPR"). This action has increased supply into tight energy markets. These reserves are back to 1984 lows (see chart) and will likely need to be replenished. Therefore, the SPR will move from a net supplier of oil to a net demander.



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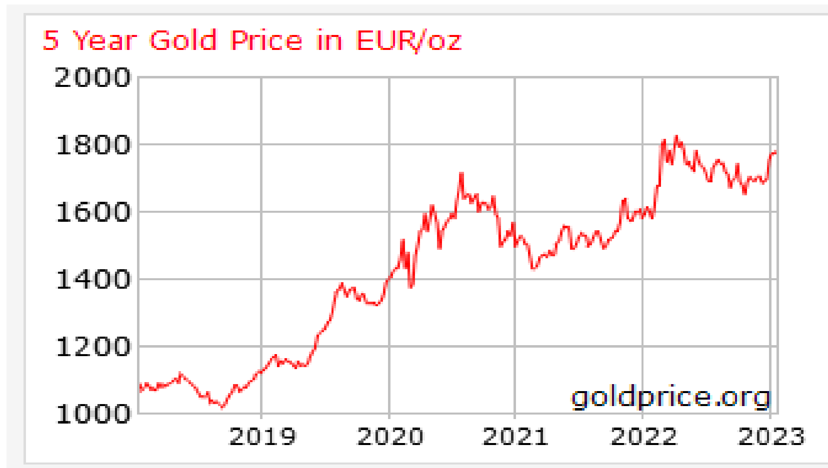
2. China has relaxed and removed zero-COVID policies which will lead to increased demand for commodities. We believe that like the reopening we have seen across the world, Chinese consumers will focus more on services such as restaurants and travel and less on goods consumption. Jet fuel prices globally have already begun to reprice based on increasing travel demand, and we believe that other commodity markets will move higher as well.

3. On a longer-term basis, we believe the global shift towards renewable forms of energy will be inflationary for commodities. The transition from fossil fuels to renewables requires massive amounts of many commodities such as aluminum, steel, and copper. Government policies have created inelastic demand for these materials to match inelastic supply. In economic terms, this is likely to, at a minimum, create long-term trends for these materials with a probability of asymmetric moves higher.

Precious metals round tripped in 2022 as their alternative store of value approach was offset by strength in the U.S Dollar. Gold, as an alternative store of value, trades in line with USD real rates. We believe that inflation will not collapse as quickly as nominal bond yields in 2023 and therefore shows gold to be a clear alternative to protect against declining purchasing power.



Equities

Equity markets around the world were challenged in 2022 as increased interest rates (both nominal and real) led to a re-rating of price multiples. The S&P 500 multiple contracted from 22 to 16 over the course of the year, and most other equity indices followed suit. Equities with higher duration risk, such as growth names, experienced much steeper declines than did value names. All GICs sectors except for energy finished the year in the red.

2023 should bring higher levels of earnings dispersion which we expect to offer an excellent opportunity set for fundamental stock picking. We see four important factors that will drive fundamental dispersions through the year.

1. Cost of labor – we believe both the wage/price spiral and the deglobalization themes to be supportive to labor prices. In addition, the continuation of the shift in demand from goods (less labor intensive) to services (higher labor intensity) around the world will likely remain inflationary in regard to labor. Firms with large labor forces are likely to see margin contractions, while less labor-intensive sectors and businesses are expected to outperform.

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2. Cost of inputs – raw material prices rose in 2022 but appear to be stabilizing. There are large differences, however, between the inflation of different inputs. Food prices continue to increase causing margin squeezes on restaurants and consumer staples firms, while the cost of other inputs, such as lumber, have declined.

3. Currency trends – rising U.S. Treasury yields caused the U.S. Dollar to rally materially in the first 10 months of 2022. Corporations have begun to digest this move, but it is likely to have a different fundamental impact on importers versus exporters. Corporate fundamentals should drive an increase in dispersion among companies with disparate import/export dynamics.

4. Cost of capital – as mentioned above, rising interest rates will have variable impacts on the debt servicing of nations, consumers, and companies. We believe that CFOs at high quality firms with strong balance sheets, will be active in looking for attractive debt financing, while others will likely need to look at more expensive forms of finance including equity. These factors should be supportive for increased corporate actions and capital market flows, all of which improve the expected rewards from active management.

In addition, we see several areas of value within equities. These areas include natural resources, value stocks versus growth stocks, Japan, and Europe.

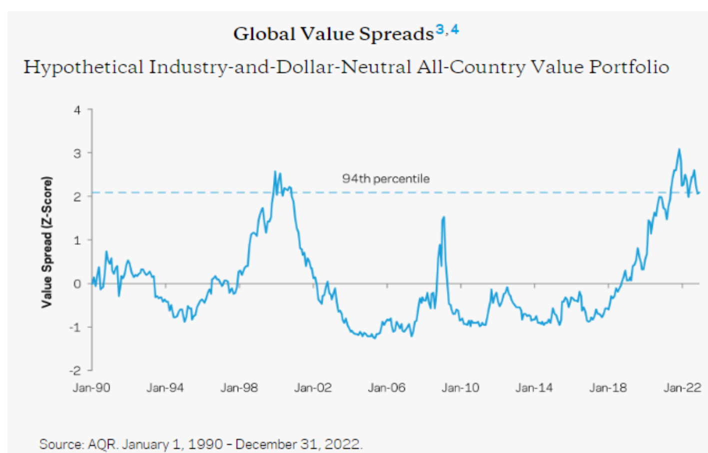
Hedge Fund Strategy Outlook

In the section above, we outlined the key drivers of dispersion and directionality across asset classes. Below, we discuss the implications for alpha generation across different hedge fund strategies.

Equity Long/Short

We look forward to strong alpha generation from stock pickers in 2023. Alpha generation across equity long/short was relatively high in 2022, but many managers experienced losses due to high levels of growth equity beta in their portfolios. We are excited by several sector-focused and style-focused strategies for 2023:

- Value equities – we think that the value style will continue to outperform growth for the next several years. While most of 2022's gains stemmed from managers' short books, we believe the attribution to be more balanced between long and short positions going forward. We think managers with a value bias in both Europe and in the U.S. are well positioned. The chart below from AQR shows that value as a factor remains at cheap extremes.



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- Natural resources – as we laid out in the commodities section above, we feel commodity markets will trend higher for the next several years. Both energy and materials companies saw excellent earnings growth in 2022, and contracting multiples meant that their equities finished the year with greater embedded value than they began the year. While energy was the standout sector within equities for most of 2022, the sector traded cheaper at the end of the year. Much like value equities, as earnings growth stabilizes, these cyclical sectors are likely to be rewarded with higher multiples on top of strong earnings growth.

Event Driven

As mentioned above, we believe that, after a year of very low capital markets activity, higher costs of capital will drive corporates to make changes. Elevated corporate activity will drive greater opportunities and returns from event driven managers. Here are several themes we expect to drive performance in the broader event driven strategy:

- Value European stress – European markets (both debt and equity) show better value than equivalent markets in the U.S. We also believe there to be more pockets of stress across European companies, offering rewards to strategies focused on those opportunities. We feel there is relative security and value in corporate debt and expect European credit managers with a relative value approach to outperform.
- Japanese activism – Japanese corporations are becoming more open to engaging with investors and are focused on unlocking shareholder value. We see excellent value opportunities in Japan that we believe are positioned to lead to strong rewards.
- M&A – large corporations and private equity firms continue to maintain large cash levels. Both sets of groups likely perceive the expected returns from mergers and acquisitions to be higher, given their higher cost of capital to complete a deal. While we anticipate robust activity, increased financing costs may dampen overall activity levels.

Credit

We believe that the trading opportunity set for relative value corporate credit managers will be excellent as corporations reengage capital markets. Increased idiosyncratic opportunities, based on individual corporate fundamentals, should drive a wider dispersion of returns. Convertible bonds suffered last year from the trifecta of low realized equity volatility, high duration risk, and large moves in their delta risk. We believe that convertible arbitrage managers should benefit from increased levels of issuance as well as from the stabilization of outflows from long-only allocators.

The opportunity set for structured credit looks less enticing. Overall, we do not think that structured credit offers compelling rewards due to illiquidity in this environment. Additionally, a growth slowdown is likely to reprice consumer credit, and a slowdown in home price appreciation will likely decrease the security of non-agency mortgage-backed securities. The corporate loan and CLO market offers excellent dispersion opportunities due to the benefit of a lagged impact of rising interest rates. However, a higher interest rate environment holds the potential for increased credit risk rather than protection from rising rates.

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Global Macro

2022 was a standout year for both discretionary and systematic global macro strategies. We believe that 2023 will offer excellent rewards from managers with a macro mindset, but returns will be most powerful when combined with micro acumen. We are less excited about the longer-term, rate-centric, discretionary global macro strategies in 2023. We anticipate that either short term managers with the ability to profit from elevated volatility or those managers with micro skills across different asset classes will benefit from the current environment.

Commodities remain very attractive from both an alpha and beta perspective.

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