In focus

Ten key themes for 2023 and beyond

March 2023

2022 was certainly a tumultuous time for investors. The year was dominated by the Federal Reserve's actions to fight inflation, particularly given the widespread perception earlier in the year that it was behind the curve. US Core inflation stood at 6% at the start of 2022 and it was clear that the Fed would need to tighten. It duly did, and at the fastest pace in four decades.

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Very few forecasters called the speed of hikes correctly but, with the benefit of hindsight, it was signposted well in advance. It was more that markets didn't accept the Fed's determination[1]. The fact that both stocks and bonds sharply fell together should not have been shocking given the valuation starting point – after all, one-fifth of the global bond market offered a negative yield entering 2022 – but the dual sell-off meant that there were very few places to hide.

Equity markets swiftly retreated early in the year as the Fed turned hawkish, but remained more or less range-bound thereafter as the debate about the depth of one the most anticipated recessions in history ebbed and flowed. The key questions were how much had already been priced in and how far would the Fed go. The resilience of most global labour markets did not make it easy for central banks but as 2022 ended, it had become clearer that the period of rapid policy tightening was slowing.

We outline below ten key themes for 2023 and the years beyond, deliberately taking a balanced perspective across a number of issues rather than falling into the trap of making specific short term forecasts. The past few years should have taught us all that it is far more important to take the long view. As part of this, assessing the point of departure provides the best clues as to what may lie ahead, primarily by focusing on current valuations.

1 The risks are still skewed to the downside for equities, albeit less so than a year ago

After such a bruising year, it is perhaps not surprising that surveys of fund managers suggest that the relative positioning in stocks vs. bonds is currently at its lowest level since 2009. The equity leg of the call is not hard to justify given the impending profits recession. The key question is how bad will it be. The implicit expectation is that it will not be deep but only three of the past eleven Fed hiking cycles since the 1950s have preceded a soft landing. Strategists also seem to have a very different model to bottom up analysts. Most strategists expect a 5% decline in US earnings this year whereas bottom-up analysts are more sanguine with predicted growth of around 5%. Inflation is not a bad thing for earnings but even positive earnings growth is unlikely unless we avoid a recession, particularly since both S&P500 earnings and margins are still well above their long run trend.

1 When equities peaked in late 2021, market expectations were that US interest rates would rise from 0.25% to 1% by the end of 2022 whereas the policy rate ended the year at 4.5%.

The current consensus is for US GDP growth of 0.3% this year (from Bloomberg), down sharply from 2.5% only eight months ago although forecasts appear to be creeping higher again as of early 2023. However, the range is from -0.8% to +2% and past forecasts of recession have always underestimated the severity of the downturn. Wall street is not main street but earnings are very sensitive to economic activity. Even if sales decline modestly, operational leverage arising from unavoidable fixed costs will squeeze margins, not to mention the existing pressures from rising wages, an inventory overhang and the still elevated level of non-wage input costs.

By way of reference, the average non-recessionary bear market decline in US earnings is -25%. That rises to -35% if the bear market is accompanied by a recession. Using the mild downturn of the early 2000's as a potential guide, S&P earnings declined from +10% growth to -20% within two years against the backdrop of a fairly modest decline in sales growth as net margin growth swung from +10% to -25%. In terms of the price response, the S&P500 has fallen by an average of 34% in the past eight US recessions whilst it 'only' declined by 20% during 2022, suggesting that a recession is still not fully priced in.

Much will depend on the path of inflation in the next few months. The market currently expects inflation to ease rapidly and the data is currently supporting this view. According to Bloomberg, the consensus for Core inflation this year is 3.6% (up from 2% in April 2022) whilst CPI swaps also imply a decline back to 3.5% this year and 2.5% by 2024. Breakeven inflation rates are also pricing in a benign longer term inflation outlook. Based on input price trends, supply chains are easing rapidly but inflation often has an annoying tendency to be sticky. Historically, it has taken several years for core inflation to half from its current rate to a more acceptable 3% and has often been accompanied with a recession[2]. Will this time be different?

Stagflation of some form is coming. Perhaps 'stagflation lite' will be the better label as the current downward direction of travel for inflation is mitigating the usual concerns that accompany such an environment. Clearly, the market currently doesn't believe Fed.

2 See 'History lessons: How transitory is inflation?' by Rob Arnott & Omid Shakernia, November 2022 and link here for more on this topic.

Schroders

There is a significant disconnect between the FOMC members published forecasts for interest rates (i.e., the 'dot-plots') and market implied expectations of US interest rates, which imply a short-term peak around 5% followed by rate cuts later this year. In the 1970s, a period with many unfortunate parallels to today, the Fed made the error of cutting rates to early only to see another wave of inflation. It will not want to make the same mistake again suggesting it will err on the side of caution. On the basis of announcements by Fed officials in early 2023, their determination remains firm. We have been warned.

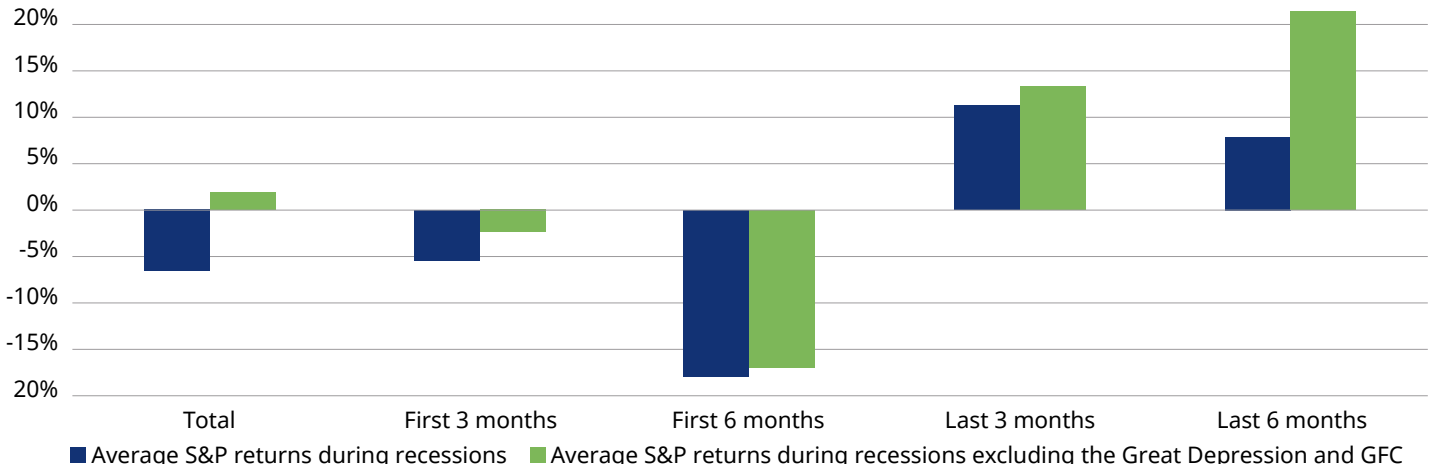
Nevertheless, aside from the prospect of declining inflation and, by implication, lower interest rates, there are some reasons to be positive. China is better placed to pick up the growth baton whilst recessions have historically not necessarily been bad for stocks, particularly after the first few months (chart below). History also suggests that the Fed has always cut aggressively in the first year after a recession has started, typically by more than 3% based on the pattern of the past 30 years.

However, the best guide to the future, at least beyond the short-term, is the starting valuation as this helps answer how much has been priced in. From this perspective, the downside risks are still very evident as the forward price-earnings multiple for the S&P has only fallen from 27x to 18x, which is essentially back to pre-pandemic levels, a period when it would have also been credible to argue that the market was already overvalued. Longer term valuation metrics such as the cyclically adjusted PE also suggest that the US is still 20% above its 15 year median although there is better value in other markets[3].

In terms of equity price targets, most strategists expect more short term pain followed by a recovery in the second half of the year. Bloomberg data highlights that the average forecast for the S&P500 for 2023 is broadly flat but again the dispersion of S&P500 year end price targets for 2023 is the widest since 2009 (high-low = 32%) and 70% greater than the average since 2008, suggesting an unusually elevated level of uncertainty.

In summary, the recession implied by an inverted yield curve does not appear to be priced into the market, at least outside some of the very deep cyclical areas such as semiconductors. Investors seem too relaxed. For example, the VIX index hardly reacted last year despite the barrage of negative news flow, at least when compared to the highs that were set in the global financial crisis of 2008 and the pandemic of 2020. Volatility has been trending modestly higher and we suspect that this will continue during 2023. The better performance of equities in Q4, which has tentatively carried over into early 2023, suggests that the market is taking the view that the worst has already passed, particularly since it has been led by cyclical areas. We are not so sure.

Average S&P500 returns are typically higher towards the end of recessions



Source: Refinitiv, Schroders Economics Group, December 2022. Note: performance statistics are based on daily S&P500 price returns. Recessions less than 12 months are excluded from the first 6 months and last 6 months calculation.

The timing of a pivot or, more likely, pause, by the Fed is currently very much up in the air but at some point the market will look through the impending profits downturn, if not recession, to better times ahead. The balance for us is to avoid any blow-ups in the short term, particularly from companies with high leverage and weakening earnings, without excluding those best placed to take part in a cyclical upswing, even if the eventual recovery is still rather half-hearted.

More importantly for asset allocators, current valuations suggest that the strong equity returns of the prior decade will not be repeated in the next with anything like the same vigour. Based on the current valuation multiple of the US, an annualised nominal return of nearer 5% is more likely over the next 5–10 years compared to almost 12% over the last decade, albeit with the big caveat that this is based on historical relationships.

3 That all said, we would stress that many pockets of the US market do offer good value and it's generally unwise to make such sweeping statements as it says more about index composition than the opportunity set. The wide dispersion of opportunity across all sectors and regions currently is relatively unusual and makes us even more cautious about making simple high level conclusions.

2 Despite a strong rebound since late 2020, Value has much further to run

The long run of underperformance of Value stocks between 2010 and 2020 was unusually extended by historical standards. The most often cited driver behind this is that falling bond yields reduced the attractiveness of shorter-duration stocks relative to structural winners. Whilst this is an easy argument to accept, in reality it is difficult to decompose how important lower rates were compared to investors simply getting carried away with stocks that had more exciting narratives. In our minds it was more that boring stocks simply fell from favour whilst the 'stay-at-home' beneficiaries of the pandemic effectively turbocharged the already established winner-takes-all market.

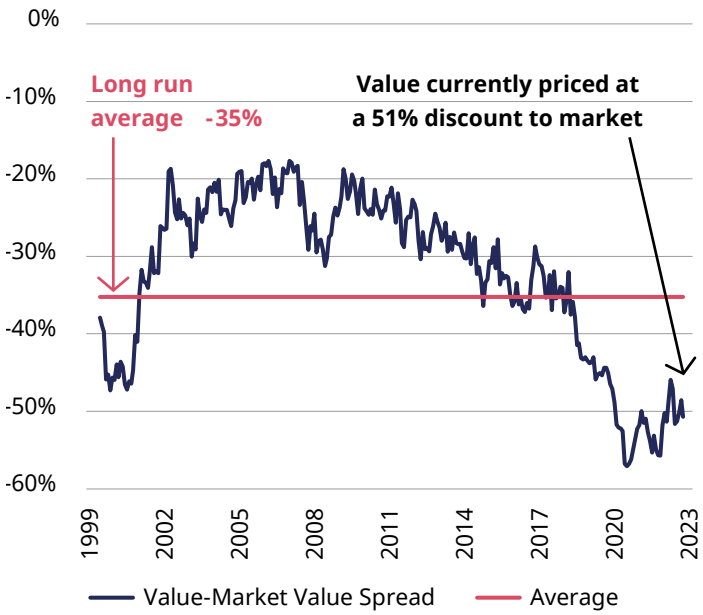
Our reasoning behind this is that the fundamental attributes of Value stocks were not compromised in terms of earnings growth and their cost of capital. If anything, the Earnings Per Share (EPS) growth rate for the average Value stock was actually better than the historical average whilst the quality of these earnings, in terms of their ability to generate stable profitability without financial leverage, was also not inferior. As investors fled towards an increasingly narrow group of victors, a long tail of high quality stocks were de-rated, simply because they were neglected. This is not an unusual outcome during periods of market exuberance and, in this context, there are parallels with the late 1990s. Investor overreaction probably lies at the heart of the Value premium and the reason why it has been so persistent since it was discovered almost nine decades ago.

The good news for Value investors today is that, despite strong returns over the past two years, the gap between the cheapest stocks and the broader market is still very wide by historical standards (chart below left hand side). This has historically been a good indicator of positive future Value returns. To assign some numbers to this, if we assume that valuations adjust back to their historical discount to the market and take into account the difference in expected earnings, Value stocks would outperform the broader market by 11.8% over the next three years (cumulative). This is similar to the expected return from a portfolio that also incorporates Quality characteristics which should also generate a smoother ride.

Despite popular opinion, it is also not the case that Value stocks today are dominated by cyclicals that are likely to face headwinds as economic growth turns down. It's worth remembering that Value also outperformed in the economic slowdown of the early 2000's and we see a similar situation emerging today. The nature of Value shifts over the course of the cycle but another consequence of the widespread neglect of most stocks outside of the FANMAG+ cohort prior to late 2020 is that it is possible to find both attractive valuations and robust fundamentals in most sectors and regions at the moment. In practice, we prefer a balanced approach, dipping into some deep-value names but hedging this with affordable quality income stocks in order to both maximise the opportunity and manage risk.

As we proceed through the cycle, the best flavour of Value is also likely to evolve with dividend yield and free cash flow expected to help identify recessionary winners more reliably in the short term than earnings and asset based valuation terms which are inherently more cyclical in nature. Once again, we would advocate a broad based exposure to a variety of value related themes in order to reduce reliance on a specific economic or market outcome.

Value vs. Market Discount (MSCI AC World)



Expected Return over the next 3 years

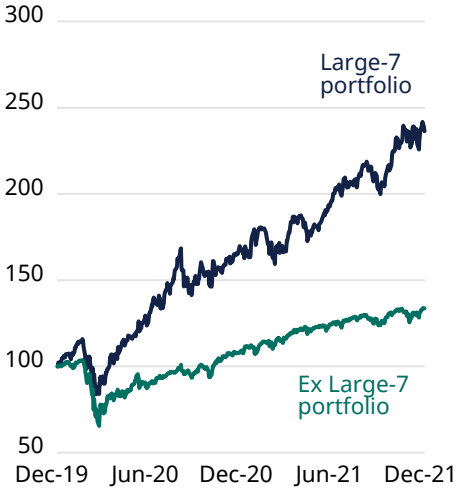
	Value	Value & Quality
Long Run Forward P/E Premium/ Discount to Market	-31%	-11%
Current Forward PE	9.6	12.6
Current Forward PE of Market	15.9	15.9
Market Forward PE Adjusted to Long Term Premium/Discount	10.9	14.2
Multiple Change Current to Long Term average	14.5%	12.6%
3 year growth in EPS (relative to ACWI)	-2.4%	-1.1%
Expected 3 year Return Relative to the Market	**11.8%**	**11.3%**

Source: QEP, IBES, data from December 1987 to December 2022. Baskets are formed from stocks in both the top third (35%) of the QEP Global Value rank and the Global Quality rank based on the MSCI ACWI universe. Expected return assumes normalisation of Forward Price/Earnings over the next 3 years. The Forward Price/Earnings numbers are based on QEP calculated portfolios. The growth in EPS is taken from FactSet.

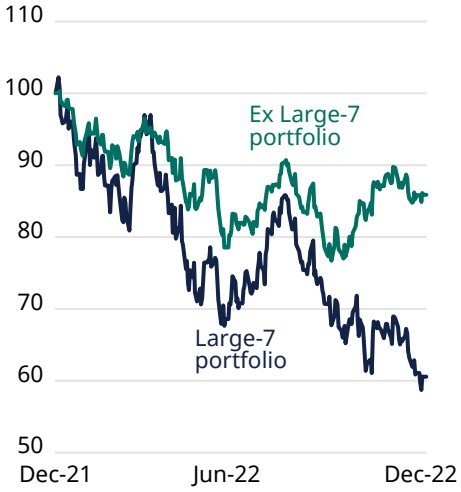
3 The honeymoon for the FANMAG stocks appears to be over

The underperformance of the big 'growth' stocks over the past two years is well documented with the largest 7 stocks in the US index retracing a large share of their prior gains (charts below).

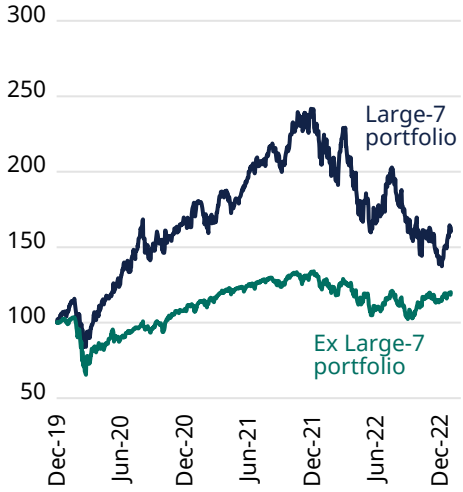
2020–2021: big winners



2022: big losers



2020–Jan 2023: converging?



Large-7 portfolio is portfolio of seven largest companies by free float market capitalisation: Apple, Microsoft, Alphabet (Google), Amazon, Tesla, Meta (Facebook), Nvidia. Data to 31 January 2023. Source: Refinitiv, Schroders.

This has been driven by multiple contraction on the back of earnings disappointment. Taking the NYSE FANG+ index as a proxy, earnings essentially plateaued during 2022, albeit after more than doubling from early 2020, whilst the PE multiple of this cohort shrunk from 50x in mid-2020 to around 20x by year end, essentially back to its pre-pandemic level. The lower multiple was a sign that investors had finally understood that the secular growth story was cyclically sensitive after all.

It is also encouraging that, in contrast to the narrowness of market leadership prior to and during the pandemic, the dispersion of stock performance within the NASDAQ index has been drifting higher for months. Dispersion is a sign of a healthy market and a boon for active management as investors price in stock specific news rather than just buying the whole basket.

However, even before the early 2023 rebound, it was still not clear that there were bargains to be had en masse. The US technology sector is currently trading on a forward PE multiple of around 21x, down from 30x a year ago, but this still represents a 20% premium to the broader US market and a 41% markup to MSCI ACWI. One way to consider whether this is reasonable is to look at the implied growth expectations built into current valuations using a discounted cashflow framework[4]. The benefit of this approach is that it essentially converts valuations into a growth rate that can then be compared to analyst forecasts whilst explicitly taking into account the quality of the company via their cost of capital.

Based on this framework, valuations at the end of 2022 appeared to have returned to some degree of normality for some of these well-known stocks but it would have been a stretch to argue they were cheap. As of early February, it would be an even more difficult argument given the recovery in January. Certain stocks, by way of example, have valuations that imply an annualised revenue growth rates that exceed analyst expectations so there is a discrepancy that needs narrowing. The sharp price moves upward experienced by many stocks at the start of 2023 has moved prices back to unjustified territory, particularly when taking into account higher costs of capital. However, sentiment remains fragile and highly dependent on short-term news flow, not least their cost cutting plans. Confidence in future earnings is also low, as indicated by the wide range of bottom-up EPS forecasts for 2023 compared to the largest non-tech stocks.

4 We focus on sales growth over the next three years assuming that current margins and profitability (as measured by ROCE) converge back to their industry average over a 10 to 15 year period depending on the stability of the company (i.e. longer fade times for more stable companies). We also assume that sales growth converges from year 4 over the subsequent 6–9 years depending on the stock.

Implied sales growth of the largest five index stocks (& Meta)

Stock	EV to Sales	Forward Price to Earnings	Market Cap ($m)	CAPM Beta (5 Year)	Estimated Cost of Capital	Sales Growth Conver-gence level	Margin Conver-gence Level	ROCE Conver-gence Level	Implied Sales Growth (3 year ann.)	Forecast Sales Growth (3 year ann.)	Implied minus 3 Year Forecast Sales Growth
Apple	5.7	18.8	2,066,942	1.04	3.0%	3.5%	7.8%	8.0%	17.0%	4.3%	12.7%
Microsoft	9.1	19.0	1,787,732	0.99	3.0%	5.9%	8.0%	7.8%	15.6%	12.4%	3.2%
Alphabet	4.1	13.7	1,145,225	1.12	3.0%	6.0%	7.8%	7.3%	8.2%	10.7%	-2.5%
Amazon	2.2	26.6	856,939	1.13	3.1%	5.8%	3.2%	7.4%	15.8%	11.8%	4.0%
Tesla	5.3	19.5	388,972	1.98	4.6%	5.4%	6.8%	7.9%	20.4%	25.4%	-5.0%
Meta	2.7	11.4	315,555	1.30	3.5%	5.7%	8.0%	7.7%	5.0%	7.6%	-2.6%

Source: Schroders, as of 31 December 2022. Forward Price to Earnings is based on smart analyst estimates over the next two years (time weighted). We compute implied and forecast growth for the selected stocks. We extract the implied sales growth from the Residual Income Valuation framework – this is the short-term growth rate which is consistent with the current valuation of the stock. The key assumptions in this framework are the cost of capital, which is the measure we use to discount future earnings back to present value, and the time periods over which we expect a company's growth rate and profitability will deviate from the market. Three year forecast annualised growth is the expected pace of revenue growth over the next 3 years based on IBES estimates.

The search for the next cohort of growth stocks is well underway but, as is often the case, this is no mean feat. The growth stocks of the future are likely to be far more dispersed across the market than the winners of the last decade and closely related to the multi-year growth potential of sustainable themes as well as clean tech, healthcare and cybersecurity. We also suspect that these new growth firms will be required to generate positive cash flows in order to finance R&D. Without the support of the FANMAGs, the technology sector may no longer be the leading driver of stock market returns but these companies will continue to dominate the mainstream indices. Disruption is the norm but investors had it too easy identifying the winners for a short period of time.

4 Sector performance will continue to be important but calling it will be hard

In contrast to the dominance of technology between 2017–2020, which was really driven by a handful of mega-cap stocks, sector dispersion has recently been high by historical standards. It has in fact only been higher in a handful of months in the past four decades. Whilst this has offered greater opportunities for active managers to outperform, calling the right sectors has been tricky. Energy stocks were the standout during both 2021 and 2022, initially driven by the global re-opening trade and then the shrinkage in supply as a result of the invasion of Ukraine. Technology and consumer discretionary have been the laggards but it is more surprising that industrials have stood their ground despite their economic sensitivity. Moreover, traditional defensive areas such as health care and staples only offered limited respite (table). This presents a genuine puzzle but one that it is probably best answered by digging under the surface as the dispersion within sectors at both the stock and industry level has also been high.

From a positioning perspective, healthcare is the current consensus overweight sector according to the Bank of America survey of global fund managers, followed by staples and energy. Given that energy stocks have proved to be quite defensive in the recent past, this suggests that positioning at least reinforces concerns about further downside, even if the top-down narrative has less conviction. Conversely, consumer discretionary is the most underweight sector. Indeed, the relative net overweight in healthcare vs. consumer stocks is the highest in fourteen years and has only been higher in two periods since 2005 (January 2006 and November 2008 as Lehman went under).

It would be easy to look at historical patterns and seek sectors that have performed well when inflation is high and falling (semis, consumer services, software, retail, electrical equipment and transport) but there is really very little history to guide us. More importantly, such analysis forgets about valuation. Whilst recognising the potential for continued high dispersion in sector performance, our preferred strategy has always been to adopt a bottom-up approach and let such concentrations build up from the stock level. It is easy to find good opportunities in most areas of the market at present, which negates the need to take on unnecessary sector risk.

MSCI World Sector annual absolute performance ranking

Rank	2015	2016	2017	2018	2019	2020	2021	2022
1	HEALTH CARE 6.6%	ENERGY 26.6%	IT 38.2%	HEALTH CARE 2.5%	IT 47.6%	IT 43.8%	ENERGY 40.1%	ENERGY 46.0%
2	CONSUMER STAPLES 6.4%	MATERIALS 22.5%	MATERIALS 28.9%	UTILITIES 2.0%	INDUSTRIALS 27.8%	CONSUMER DISCRETIONARY 36.6%	IT 29.8%	UTILITIES -4.7%
3	CONSUMER DISCRETIONARY 5.5%	INDUSTRIALS 12.9%	INDUSTRIALS 25.2%	IT -2.6%	COMM. SERVICES 27.4%	COMM. SERVICES 23.0%	REAL ESTATE 28.7%	HEALTH CARE -5.4%
4	IT 4.8%	FINANCIALS 12.5%	CONSUMER DISCRETIONARY 23.7%	CONSUMER DISCRETIONARY -5.5%	CONSUMER DISCRETIONARY 26.6%	MATERIALS 19.9%	FINANCIALS 27.9%	CONSUMER STAPLES -6.1%
5	COMM. SERVICES 2.5%	IT 11.5%	FINANCIALS 22.7%	REAL ESTATE -6.4%	FINANCIALS 25.5%	HEALTH CARE 13.5%	HEALTH CARE 19.8%	FINANCIALS -10.2%
6	REAL ESTATE 0.2%	UTILITIES 6.0%	HEALTH CARE 19.8%	COMM. SERVICES -10.0%	MATERIALS 23.3%	INDUSTRIALS 11.7%	CONSUMER DISCRETIONARY 17.9%	MATERIALS -10.7%
7	INDUSTRIALS -2.1%	COMM. SERVICES 5.7%	CONSUMER STAPLES 17.0%	CONSUMER STAPLES -10.1%	HEALTH CARE 23.2%	CONSUMER STAPLES 7.8%	INDUSTRIALS 16.6%	INDUSTRIALS -13.2%
8	FINANCIALS -3.4%	CONSUMER DISCRETIONARY 3.1%	REAL ESTATE 14.6%	INDUSTRIALS -14.5%	REAL ESTATE 23.0%	UTILITIES 4.8%	MATERIALS 16.3%	REAL ESTATE -25.1%
9	UTILITIES -6.6%	REAL ESTATE 2.8%	UTILITIES 13.7%	ENERGY -15.8%	CONSUMER STAPLES 22.8%	FINANCIALS -2.8%	COMM. SERVICES 14.4%	IT -30.8%
10	MATERIALS -15.3%	CONSUMER STAPLES 1.6%	COMM. SERVICES 5.8%	MATERIALS -16.9%	UTILITIES 22.5%	REAL ESTATE -5.0%	CONSUMER STAPLES 13.1%	CONSUMER DISCRETIONARY -33.4%
11	ENERGY -22.8%	HEALTH CARE -6.8%	ENERGY 5.0%	FINANCIALS -17.0%	ENERGY 11.5%	ENERGY -31.5%	UTILITIES 9.8%	COMM. SERVICES -36.9%

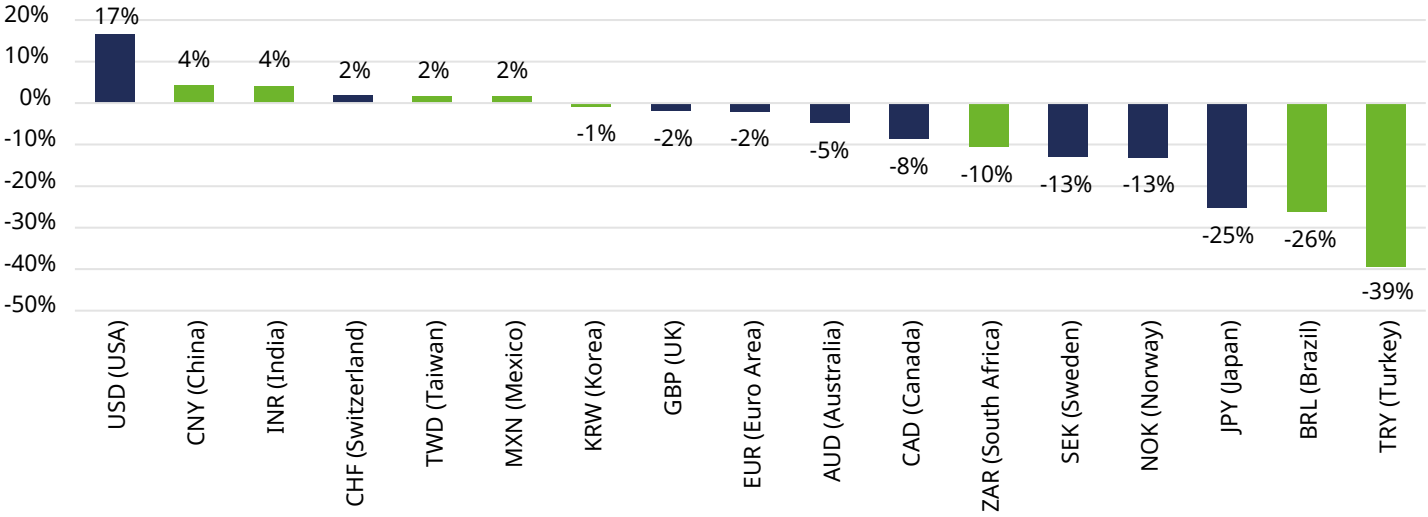
Source: Schroders, MSCI, Datastream. Based on USD absolute returns of the MSCI World (NDR) sector indices.

5. The USD's crown has slipped

The US dollar was the key winner of last year's volatility, rising at one point by almost 19% on a trade weighted basis before peaking in late September and then rapidly retracing. Nevertheless, it was still up by almost 9% over the year, constituting a significant headwind to non-US equity markets performance. The turning point was clearly driven by expectations that US inflation has peaked and, by extension, interest rates will start to fall sometime this year. Whilst we don't necessarily share this view (in all honesty, we don't know), this would be bad news for the dollar. Investor positioning confirms this bearish view with the Bank of America survey currently showing close to an unprecedented conviction that the dollar will continue to depreciate from here. Given its status as the world' reserve currency of choice, this matters for multiple reasons but from the context of equity strategy, its main impact is to effectively make non-US assets more attractive, most notably emerging markets.

In terms of who will be the winners should dollar weakness persist, once again we return to valuations. The chart below plots the real exchange rate deviation from the historical average and suggests that the US dollar is still the most expensive currency out of the major markets followed by the Chinese Yuan. The Japanese Yen in particular appears particularly cheap despite retracing a significant share of its recent weakness towards the close of 2022.

Real trade-weighted exchange rates: Deviation from 15 year average



Source: QEP, Refinitiv, JPMorgan as at December 2022. Using JPMorgan CPI Real Effective Exchange Rates (REER).

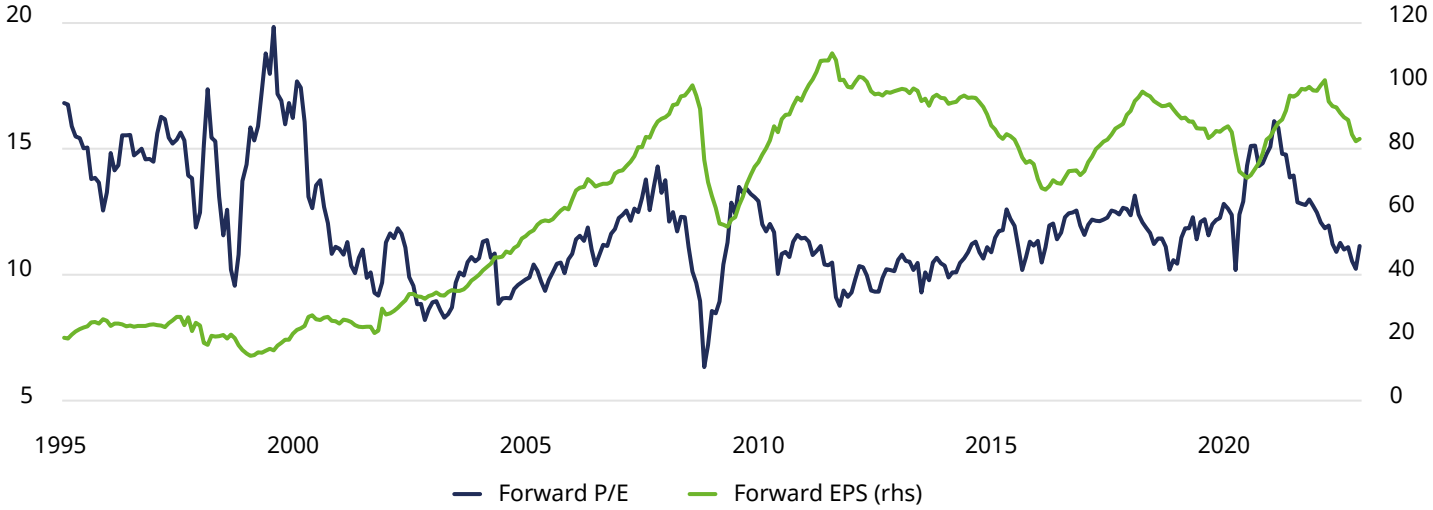
However, we would be cautious about expecting a straight line for dollar weakness going ahead. Alongside expecting further volatility in equity markets, it would be wise to factor in bouts of risk aversion which are typically dollar friendly. Where we are permitted to hedge currencies in our funds, we have significantly reduced our hedges in recent months but have not removed them altogether for those strategies that have tighter risk parameters.

6. The stars are aligning for emerging market outperformance but it will be more like 2016 than 2003

Emerging markets actually held up surprisingly well during 2022, lagging developed markets by a relatively modest 2%, However, their weakness over the past three years has essentially wiped out all of the gains posted in the prior decade and a half. As with developed markets, it doesn't make sense to think about emerging markets as a homogenous asset class but some general comments supporting the emerging market bulls are:

- **Emerging markets are further ahead in the policy cycle:** Most central banks in the region started raising interest rates before the US and the trough in the EM-DM GDP growth differential is likely to have passed, particularly given the expected slowdown in developed markets and China emerging from its zero covid policy. Inflation has also peaked in emerging markets (and was never really an issue in China) although divergent inflationary pressures mean that the exit from policy tightening will be staggered. Central banks in Latin America will probably take the lead followed by Emerging European and Asian central banks.
- **China reopening:** The Chinese economy clearly suffered in 2022 by being tethered to the country's zero-Covid policy, which has been rapidly dismantled, as well as stress in the real estate sector. Challenges certainly remain as the reopening process is proceeding faster than China is epidemiologically ready for meaning that the recovery will be erratic as the move to an endemic state will bring exit waves. In terms of the real estate sector, prior tightening in combination with a regulatory clampdown on developer leverage led to a crisis of confidence and a marked downturn in sales in 2022. The authorities are incrementally adding policy support but the situation is unlikely to be resolved quickly. There are also signs that the vigour behind the regulatory crackdown on key sectors in the drive towards common prosperity, which primarily hit the big tech stocks in 2021 is also easing. Finally, the announcement in late 2022 that US officials had gained access to audit documents on companies in China and Hong Kong for the first time, has dramatically reduced the delisting threat that was hanging over 200 Chinese companies listed in New York as ADR's.
- **A weakening USD provides a lifeline for emerging markets:** For the best part of the past two decades, the performance of EM relative to DM has behaved like a geared play on the dollar: As noted above, emerging market currencies appear cheap whilst a softer US dollar should allow EM currencies to recover whilst also alleviating pressure on EM central banks and financial conditions.
- **Valuations are relatively cheap:** The de-rating in emerging markets since 2020 has returned valuations back to levels seen at the start of the last decade, although this may simply reflect concerns about earnings growth and geopolitical risks. However, earnings revisions for emerging markets appear to have bottomed in recent months relative to developed markets and this trend is expected to continue as the latter slows (chart over the page).

MSCI EM Index 12 month forward P/E and EPS



Source: Refinitiv Datastream, MSCI, IBES, Schroders Strategic Research Unit. Data as at December 2022.

Emerging markets have recently bounced strongly in response to the above, but investors should continue to look for opportunities to add exposure. The early winners have been technology companies in South Korea and Taiwan that offer good structural growth. The coming months may provide further opportunities to add to economic sensitivity as investors look through the current cycle. While a number of risks remain, not least of which is ongoing geopolitical tension, markets often look through this and valuations are probably sufficiently low to compensate for such risks.

Longer term, the Chinese economy in particular faces multiple structural headwinds, not least the increasing drag from an aging population. India is in fact expected to overtake China as the world's most populous country this year. China's shrinking labour force will increasingly become a drag on growth in the decades ahead. According to Goldman Sachs, the current rate of GDP growth of close to 5% will half in the next decade and continue to decline thereafter. The other elephant in the room is China's stance towards Taiwan. At present, we are assigning the prospect of a military incursion a very low probability but its implications are so extreme, far dwarfing Russia's invasion of Ukraine, that it should not be discounted completely.

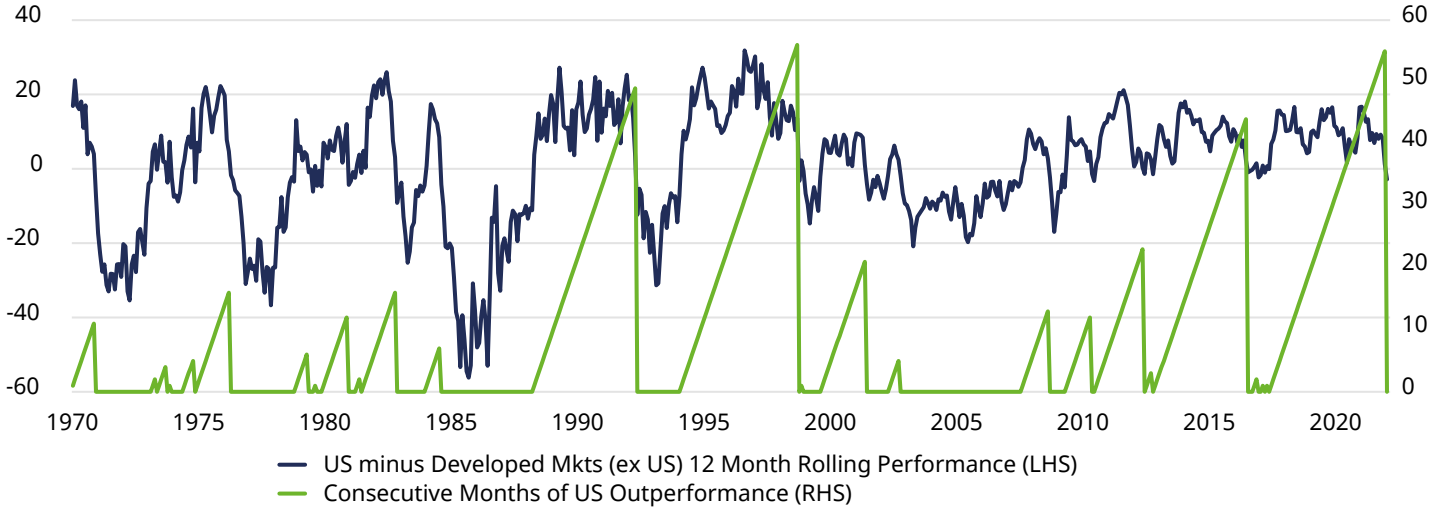
Despite the stars aligning for emerging markets, the recovery in performance is probably going to look more like 2016 than the start of a multi-year period of outperformance along the lines of 2003[5]. More sustained EM outperformance would require an earnings super cycle which seems unlikely. Finally, what could go wrong for emerging markets? In short, China needs to avoid botching its re-opening as it would be unusual for EM to outperform without it being led by China. There is also a risk that China is too successful as its re-opening may lead to renewed upward pressure on commodities and by extension inflation, thereby delaying Fed easing.

7. US outperformance over the past decade is unlikely to be repeated but still best to take a bottom up view when taking regional positions

History suggests that, as with sectors, rotation in regional market leadership is the norm. The US has been the standout equity market since 2010, although this has been exaggerated by its tech heavy composition and the outsized impact of a small number of mega cap stocks, particularly since 2017. Nevertheless, it does represent one of the longest streaks of the US outperforming non-US DM stocks over the past four decades, and only just short of the record set in 1999 (chart). It obviously begs the question of whether we are now likely to see a reversal.

5 Emerging markets topped the regional leader table in 2016 and again in 2017, which represented a rather short lived anomaly in more than a decade of US dominance.

US versus Non-US rolling annual returns (%) and consecutive months of outperformance



Source: Schroder, MSCI, Datastream. Rolling 12 month USD performance since December 1970. Developed Markets (ex US) are represented by MSCI World ex US Index (NDR) whilst US market performance is presented by S&P500 Index (NDR).

The table below breaks down regional performance by year as well as splitting the 2000s into two distinct periods. It is notable that the best performing region in the 2011–2022 period (the USA) was the second worst performing in the prior decade whilst Emerging markets moved from top to bottom. As an aside, the UK's appearance at the top of the leader board in 2022 was primarily driven by its high exposure to energy stocks (table).

However, we cannot just focus on performance as valuations are again critical. At first glance, the case for a continuation of US dominance is not compelling. The US market is currently trading on a forward PE of 18.3x, a 48% premium to the rest of the developed world and a 59% premium to emerging markets. Historical comparisons also highlight the egregious valuation of the US. For example, its cyclically adjusted PE ratio, which smooths earnings over 10 years, is currently 20% above its 15 year average whereas regions such as Japan are Emerging markets are at a 20% discount. Whilst not a good guide to the short-term, starting valuations are the best available indicator of future prospective returns over longer periods of time but the real question is to what extent the US mark-up is justified by its superior earnings quality and lower risk premium.

As we did with the largest index stocks, one way to answer this is consider the implied growth of each region, effectively considering what is priced in today by applying an appropriate discount rate to future earnings assuming valuations today are correct. This is calculated at the stock level and then aggregated up to the mainstream MSCI benchmarks using their constituent weights. It explicitly takes into account the higher quality of most US stocks via their lower discount rate. We focus on sales growth by assuming that margins and ROCE converge to the levels included in the table over 10 to 15 years depending on the stability of the underlying companies. We solve for revenue growth over the next three years and then assume that growth will revert from year 4 over the following decade (once again depending on the stability of each company).

This suggests that the implied revenue growth for the entire US market is just shy of 12% annualised over the next three years, almost double analysts bottom-up forecasts of 6.6% which will almost certainly be revised lower in the coming months. In contrast, the implied growth expectation for developed markets ex US and emerging markets are far more realistic, if not indicating good value. In summary, the scope for disappointment in the US is greater even after taking into account its superior profitability and lower discount rate.

Another straightforward approach to estimating expected returns is to apply a similar framework to the one we used earlier to quantify the Value opportunity. This simply assumes that market valuations adjust back to their long run average over the course of the next three years whilst also taking into account the relative difference in earnings growth, as projected by analysts bottom-up. On a cumulative basis, the return differential between the developed World ex US and the US is just over +19% between now and 2026, similar to the disparity with between emerging markets and the US.

Regional annual absolute performance ranking

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2000–2010[1] (ANNUALIZED)	2011–2022[1] (ANNUALIZED)
USA 1.4%	EUROPE EX UK 21.3%	USA 31.8%	USA 12.7%	JAPAN 9.6%	EM 11.2%	EM 37.3%	USA -5.0%	USA 30.9%	USA 20.7%	USA 26.5%	UK –4.8%	EM 11.7%	USA 12.3%
UK -2.6%	EM 18.2%	EUROPE EX UK 27.6%	EM -2.2%	USA 0.7%	USA 10.9%	EUROPE EX UK 26.8%	JAPAN -12.9%	EUROPE EX UK 24.8%	EM 18.3%	UK 18.5%	JAPAN -16.6%	EUROPE EX UK 2.4%	EUROPE EX UK 5.0%
JAPAN -14.3%	USA 15.3%	JAPAN 27.2%	JAPAN -4.0%	EUROPE EX UK -0.6%	JAPAN 2.4%	JAPAN 24.0%	UK -14.2%	UK 21.0%	JAPAN 14.5%	EUROPE EX UK 15.7%	EUROPE EX UK -18.0%	UK 2.2%	JAPAN 4.3%
EUROPE EX UK -15.3%	UK 15.3%	UK 20.7%	UK -5.4%	UK -7.6%	UK -0.1%	UK 22.3%	EM -14.6%	JAPAN 19.6%	EUROPE EX UK 10.9%	JAPAN 1.7%	USA -19.8%	USA -0.5%	UK 3.9%
EM -18.4%	JAPAN 8.2%	EM -2.6%	EUROPE EX UK	EM -14.9%	EUROPE EX UK	USA 21.2%	EUROPE EX UK	EM 18.4%	UK -10.5%	EM -2.5%	EM -20.1%	JAPAN -2.3%	EM 1.0%

Source: Schroder, MSCI, Datastream. Based on USD absolute returns of (NDR) MSCI regional indices (NDR) since 31 December 1999.
[1]Absolute returns are annualized across the specified periods.

Implied growth vs. forecast growth by major region

MSCI Indices	United States	Developed Mkts (ex US)	Emerging Mkts
Estimated Cost of Capital	3.2%	4.0%	6.1%
Sales Growth (convergence level)	**3.9%**	**3.4%**	**4.4%**
Margin (convergence level)	**6.8%**	**6.2%**	**6.2%**
ROCE (convergence level)	**7.1%**	**6.6%**	**6.9%**
Estimated Implied Revenue Growth (3 year ann.)	11.8%	3.9%	9.0%
Forecast Revenue Growth (3 year ann.)	6.6%	5.2%	11.1%
Implied growth less 3 year forward growth	**+5.2%**	**-1.3%**	**-2.2%**

Source: Schroders, as of 31 December 2022. We compute implied and forecast growth for the major indices aggregated up from stock level constituents using MSCI index weights. We extract the implied sales growth from the Residual Income Valuation framework – this is the short-term growth rate which is consistent with the current valuation of each index stock. The key assumptions in this framework are the cost of capital, which is the measure we use to discount future earnings back to present value, and the time periods over which we expect a company's growth rate and profitability will deviate from the market. Three year forecast annualised growth is the expected pace of revenue growth over the next 3 years based on IBES Consensus Estimates.

In terms of positioning, surveys suggest that investors are not currently being very brave when it comes to regional allocations. Emerging markets have moved to a modest overweight whilst investors are modestly underweight the US. Other regions are in the middle of the pack. This feels too conservative, particularly for investors with a value bias, who would naturally use the US as a source of funding for cheaper prospects elsewhere. That said, for our portfolios that are more balanced between Value and Quality, regional biases are not very significant at the moment compared to their history. For example, both emerging markets and Japan appear very cheap but this reflects their lower quality whilst some premium for the US seems appropriate, albeit not to the extent that its current valuation suggests.

We are always wary of making bold regional or sector forecasts and prefer to start at the bottom with stock selection and then identify any resulting top down themes which may need to be managed from a risk perspective. However, the balance of probabilities do suggest that the hegemony of the US market has also peaked for now as valuations are far more attractive in other regions and the superior quality of US stocks is no longer as compelling.

Asset allocators appear to be lining up behind this trade as the latest Bank of America survey of fund managers show that the proportion who say they are overweight in US equities has dropped to nearly an all time low. Moreover, last month represented the largest outflow from the US since the survey started. That said, there are many stocks in the US that we find attractive despite the market as a whole looking expensive and, conversely, avoid many cheap for a reason stocks elsewhere. The net result is that for our non-Value focused funds, we do not feel the need at the moment to take outsized regional positions.

Expected returns over next 3 years (cumulative)

MSCI Indices	MSCI US	MSCI World ex US	MSCI EM
Long Run Forward P/E Premium/Discount to Market	5%	-5%	-16%
Current Forward PE	17.8	13.2	11.9
Current Forward PE of Market	15.9	15.9	15.9
Market Forward PE Adjusted to Long Term Premium/Discount	16.7	15.2	13.4
Multiple Change Current to Long Term average	-6.4%	15.2%	12.4%
3 year growth in EPS (relative to ACWI)	0.2%	-2.0%	1.3%
Expected 3 year Return Relative to the Market	**-6.2%**	**12.9%**	**13.8%**

Source: QEP, IBES, data from December 1987 to December 2022. Baskets are formed from stocks in both the top third (35%) of the QEP Global Value rank and the Global Quality rank based on the MSCI ACWI universe. Expected return assumes normalisation of Forward Price/Earnings over the next 3 years. The Forward Price/Earnings numbers are based on QEP calculated portfolios. The growth in EPS is taken from FactSet.

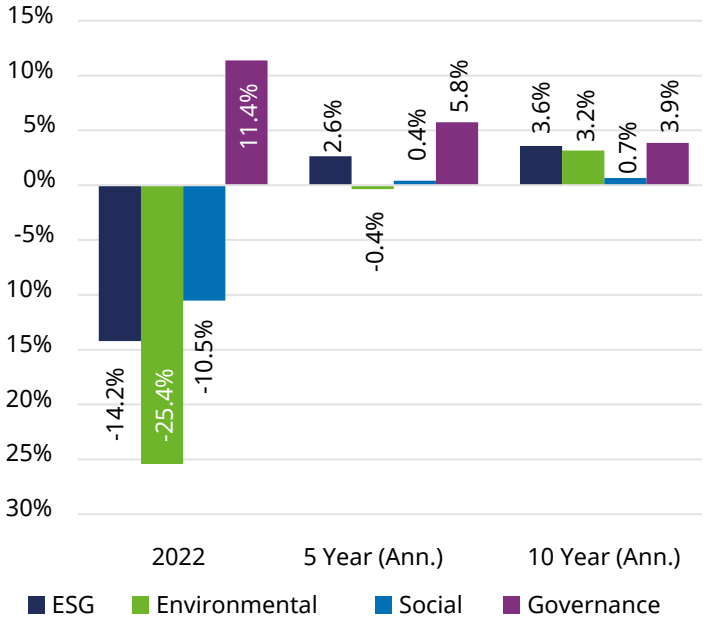
8. Sustainable investing has been challenged of late but this reinforces the need for a forward looking approach

2021 and 2022 proved to be a an exceptionally difficult backdrop for sustainable strategies, particularly those that avoid the standard exclusions related to business involvement. Whilst exclusions have not detracted from performance historically, the strong recovery in energy stocks since November 2020, complimented by the attractiveness of defensive industries in a falling market during 2022 (tobacco) have clearly been a strong headwind to sustainable strategies. Similarly, the war in Ukraine has also supported defence stocks.

part driven by the fact that they possess a value bias and have progressively shifted to identifying enablers and innovators as well as the best in class stocks. In short, careful implementation of Sustainability considerations in a way that does not compromise an anchoring in Value and Quality characteristics should not lead to an unexpected performance outcome. More generally, we regard the current headwinds as largely transitory and retain high conviction that ESG risks will increasingly be priced over time. Conversely, the best performing stocks will not only have the best fundamentals but also prove to be the most adept at adapting their business models to face the sustainability challenge head on. [6]

6 See Link for more on this topic.

An 'Anti ESG' market



Top 10 industries 2022

Rank	QEP Industry	Relative Perf.
1	Coal	+81.6%
2	E&P O&G	+67.2%
3	Equipment O&G	+63.9%
4	Integrated O&G	+61.4%
5	Refiner O&G	+39.4%
6	Transportation O&G	+33.8%
7	Tobacco	+31.0%
8	Mining	+30.7%
9	Defence & Aero	+29.6%
10	Education	+25.7%
	MSCI AC World	**-18.4%**

Source: QEP, Schroders. LHS: QEP ESG Ranks, total return performance of the top-quintile (20%) minus the bottom quintile for the relevant periods as at 31 December 2022. Bottom Right: QEP Industry performance versus MSCI AC World in USD, as at 31 December 2022.

Naive approaches to ESG such as passive sustainability indices lagged well behind during 2022 whilst the average ESG manager underperformed by 4.0% according to Morningstar and by 1.7% since the end of 2020.

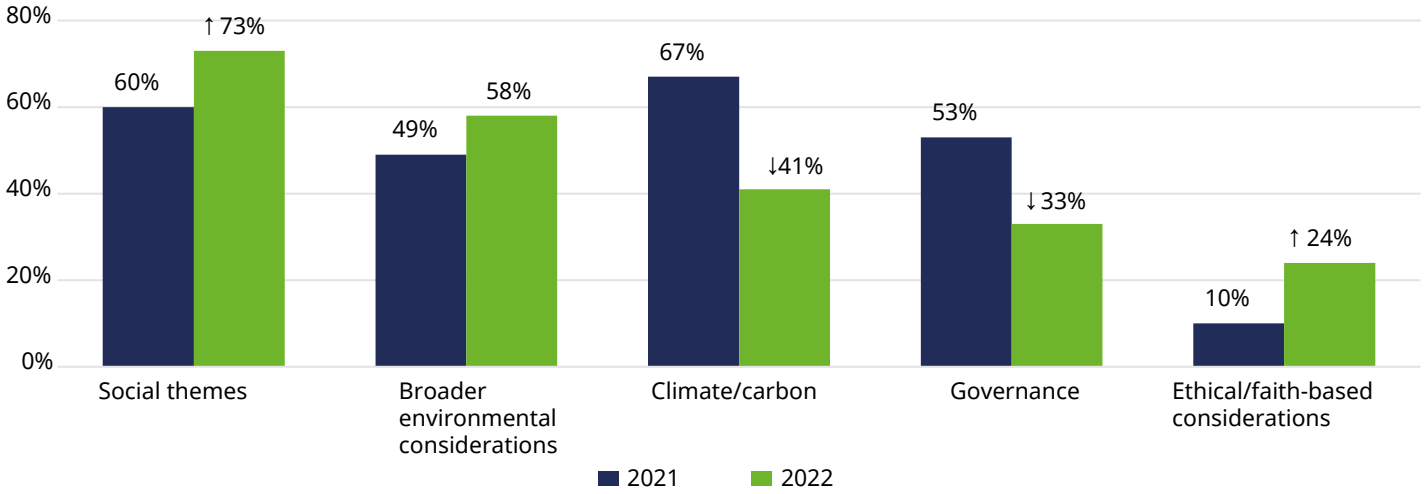
It is also not a coincidence that active ESG managers tend to have a growth bias which has worked to their detriment given the de-rating of this area in the recent past.

The ESG winter has reinforced the need to focus on implementation as well as taking a forward looking approach. Our own ESG funds did outperform during 2022, in no small

9. Emerging sustainable trends: human capital and biodiversity

It is not surprising that climate related investing has dominated the sustainability agenda to date given its increasing political focus whilst company specific information has become more abundant, albeit there is still a long way to go in terms of disclosure. The focus is also rightly shifting from identifying high carbon emitters today to both climate leaders – companies with credible carbon reduction strategies – and climate enablers – those that will help facilitate energy transition. However, investors are increasingly looking more broadly and are increasingly focusing on social and broader environmental factors (chart over the page).

Sustainability issues that are the priority focus areas (2022 vs. 2021)



Source: FTSE Russell 2022 Asset Owner Survey. The question is 'Which sustainability issues does your organization consider as a priority focus?' Segment = currently implementing, evaluating or plan to evaluate sustainable investment.

This accords with our own research focus. In a collaborative project with Schroders Sustainable Investment Team, we have recently focused more closely on human capital. Employees are a key stakeholder for most industries and we have found that the outcomes of good human capital management can be measured. Despite some data limitations related to company disclosure, early empirical results suggest that human capital returns are positively correlated with forward excess returns over multiple time horizons and across many sectors, even after controlling for profitability and a variety of other factors. In short, we see multiple paths for human capital management to impact balance sheets and the P&L. This topic will remain part of our ongoing research agenda during 2023.

With regard to expanding environmental focus, it is clearly encouraging corporates are starting to adopt net zero emission targets but broader environmental threats have enjoyed much less air time. This is starting to shift, with increasing recognition of the vital role that Nature plays in the functioning of our economies. In 2021, the World Economic Forum identified biodiversity loss and ecosystem collapse as one of the top five risks in terms of likelihood and impact in the coming decade behind infectious diseases, climate action failure, and weapons of mass destruction.

Biodiversity is an important element of natural capital and, put simply, refers to the variety of living things in a given area. This variability is vital for the healthy functioning of ecosystems which in turn provide a multitude of goods and services that underpin our economies. These include everything from direct goods such as food and energy to services provided by nature, such as water filtration, crop pollination, carbon sequestration, climate regulation and flood protection. The World Economic Forum (WEF) estimates some $44tn of economic value generation (>50% of global GDP) is either moderately or highly dependent on nature.

Risks surrounding nature and biodiversity loss are highly relevant to companies, which are embedded in the natural environment through their dependence and impact on natural resources. We see four key risks for corporates:

- **Operational and supply chain risks:** particularly relevant for companies operating in regions with higher exposure to nature-related risks and for end markets that are reliant on goods and services provided by nature, including the food, agricultural, apparel and forestry industries
- **Regulatory risks**: The policy landscape is still nascent when it comes to regulating nature-related risks, but this is evolving quickly with major economies committing to ambitious nature goals and regulation starting to follow suit
- **Risks to consumer and investor sentiment:** Consumers and investors are increasingly attuned to environmental issues, presenting a risk for laggards, who may suffer reduced demand for their products and services or an increased cost of capital
- **Liability risks:** Includes any fines or pay-outs that may arise as parties seek compensation for losses associated with nature loss, and also covers legal costs, insurance and financing costs

The visibility of nature-related and biodiversity risks is improving. Policy momentum is building and investors and regulators are increasingly attuned to corporate environmental performance beyond climate change. Moreover, progress on policy and reporting frameworks for climate change can serve as a blueprint for nature-related risks, enabling a much swifter response from regulators and investors. Biodiversity is already an element of our approach to assessing the environmental risks companies face but is also a major research focus for the early part of 2023 across the three pillars of land, atmosphere and marine/freshwater. We fully expect other investors to follow suit.

10. The big picture is still uncertain and investors will need to be far more nimble than in the past

There are known unknowns, such as the pace of Fed tightening or the speed of China's reopening, and there are the unknown unknowns, which tend to emerge with no warning, such as the covid pandemic. That said, it is useful to highlight an evolving longer term threat that is impossible to price but should remain at the back of our minds, namely deglobalisation. We have lived through several decades characterised by a relatively stable economic and political backdrop. Globalisation has provided a tailwind to investment returns. However, most of the trends that have existed since the fall of the Berlin wall are unlikely to be repeated and, in many cases, appear to be going into reverse. The prospect of more unpredictable growth, higher interest rates and more volatile markets is a natural consequence of a less certain future. In practical terms this may lead to more state intervention and, in the extreme, the greater risk of war, both of the cold and hot kind.

Investors should consider what this means and whether traditional allocation approaches are still fit for purpose in a world where expected returns are expected to be lower, at least in a risk adjusted sense. Along with the rise of thematic investments which straddle the traditional classifications of regions, sectors and styles, one consequence is that we believe that alpha will become far more dominant over beta. Portfolios may also need to incorporate more structuring to obtain specific outcomes, particularly downside protection. In essence, investors will need to be more agile in how they respond to evolving market opportunities. Once again, a bottom up approach is best suited to this but even asset allocators may want to consider building their portfolios with more building blocks (e.g. implementation differentiation via regional mandates) so that they are better equipped to react quickly.

Final thoughts

Whilst not wanting to finish on a gloomy note, the reality is that the future is always uncertain, albeit even more so at the moment. We have attempted to highlight some of the key themes that are currently on our minds but markets are constantly evolving as they reassess the prevailing paradigms whilst also tending to overreact at the same time. Fear and greed are perhaps the only two constants in investing. However, this creates opportunities. The silver lining is that the current transition from the narrow growth driven market, which dominated the best part of the last decade, to a more indeterminate environment provides greater scope for active management to justify its existence.

Our key take out is that history will only provide some of the answers and predicting the future is fraught with difficulty. Instead, it is better to take the opportunities that are pushed our way and spend more time thinking about what is priced in today. Our preference is to build diversified portfolios bottom-up in order to capture multiple themes whilst scaling up our insights to exploit the broadest possible opportunity set. Finally, risk management should be far less concerned about volatility and correlations and focus instead on what could go wrong across a range of scenarios. As this paper has hopefully illustrated, these risks need to be identified first before they can be managed.

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