GLOBAL LONG-TERM UNCONSTRAINED

Outlook 2023 – Mid Year Update

JULY 2023 For institutional, professional and wholesale Investors only

Recession fears might be like waiting for Godot

We stick to our view of a sharp slowdown instead

Below, we review our outlook for 2023, as part of our mid-year update. It has already been an eventful first half of the year, marked by regional bank failures, flare ups in geopolitical risks, ongoing central banks tightening, and recession fears that remain omnipresent. Despite this, we find ourselves leaving our predictions unchanged.

Zehrid Osmani

Head of Global Long Term Unconstrained

Senior Portfolio Manager

Notably, our two key predictions remain firmly unchanged:

(i) 2023 will be a year of high forecast risk and prediction error. This is due to the broad range of potential outcomes on inflation, interest rates, macroeconomic cycle, corporate earnings cycle and geopolitics.

(ii) The word "pivot" has already been used aplenty, generating a healthy bull-bear debate. Hopes of a central bank pivot in 2023 now appear to be rapidly waning, and coming towards our prediction of 'no-pivot' later into 2024.

Our additional predictions below therefore carry high forecast risk, but remain unchanged on all fronts:

Inflation – stickier and longer lasting

Monetary policies – no central bank pivots this year

Macroeconomic cycle – sharp slowdown rather than recession

Corporate earnings cycle – recession in earnings growth

Our stock level conclusion therefore remains that we want to continue to focus on companies with:

(i) **resilient earnings growth:** given risk of ongoing earnings downgrades

(ii) **pricing power:** to help protect margins from the stickier inflationary backdrop

(iii) **solid balance sheets:** which will provide financial resilience, in case we head into a recession, and;

(iv) **structural growth prospects:** given the low growth outlook.

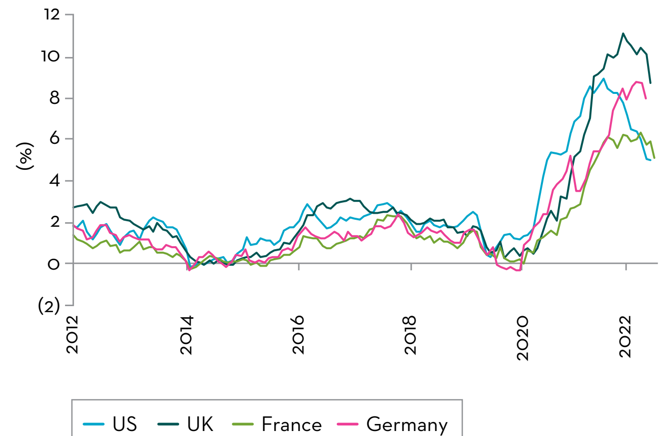
Key predictions for our 2023 mid-year outlook update

- Inflation to remain stickier, i.e., higher and longer lasting, meaning central banks are unlikely to reach their inflation targets this year
- We expect the pressures driving inflation to start to ease in H2, notably as a result of the favourable base effect
- All eyes should remain on wage inflation as a key determinant of mid-term inflation
- Monetary policies are likely to continue hiking rates, although we are nearing the end of the cycle
- A central bank pivot is unlikely to happen until sometime in 2024
- The decoupling of global central bank monetary policies versus the Chinese central bank is likely to be a feature of H2
- Our central scenario on the macroeconomic cycle remains sharp slowdown rather than recession for both Global and US economies
- For Europe, our central scenario remains stagflation, this is the combination of inflation and low economic growth
- We maintain our probability of recession at 30-35%, despite the broad consensus view that there is high likelihood of a recession in 2023
- China's economic momentum remains key to the global economic cycle: we expect ongoing recovery in Services in H2
- The rising risk of a recession, however in the US in 2024 could be an important focal point for investors
- Following downgrades, the corporate earnings cycle is already in recession, with the risk of more to come in H2
- Equity valuations are now less supportive, although European and Asia equities remain more attractive
- Valuation discipline paramount at this stage in the cycle
- Key market risks continue to center on inflation, interest rates, and geopolitics
- Volatility, both intra-market and across markets could be high as a result of the elevated uncertainties
- Investors need to keep focusing on companies with resilient earnings, pricing power, solid balance sheets and structural growth exposures
- Thematic opportunities continue to abound for long term investors
- Our key focus themes are Energy Transition, Artificial Intelligence, and Technological & Geopolitical Fragmentation

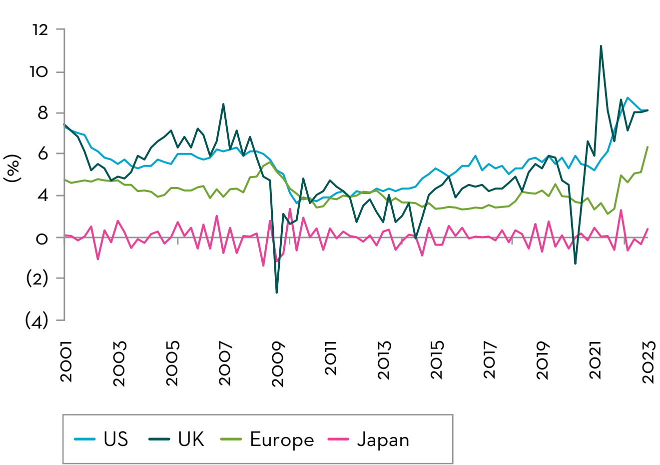
Inflation to be longer lasting

We continue to expect inflation to remain higher and longer lasting, given (i) the creeping wage inflation trends, (ii) ongoing localised supply chain bottlenecks, and (iii) the trend towards nearshoring and onshoring leading to diseconomies of scale. Technological and geopolitical fragmentation is further exacerbating the third point. We expect inflationary pressures to be less pronounced in H2, as a result of the base effect from last year. But we still expect that key central banks will miss their inflation targets this year, and actually might struggle to reach them even in 2024 - although they will be likely getting closer to hitting them.

Headline CPI inflation on a monthly basis (%)



Wage inflation nominal (%)



Source: FactSet. For CPI data is shown as at 30 April 2023; for France as at 31 May. Wage inflation data shown to 31 March 2023. US: Atlanta Fed wage tracker, Europe: Eurozone negotiated wages, Japa; cash earnings, UK: total pay.

All eyes need to remain on wage inflation as the key contributor to inflationary pressures in the mid-term, as we have detailed in our inflation report last year. Elevated wage inflation has the potential to turn inflation pressures from being frictional to becoming more structural, and therefore longer lasting.

Monetary policies: premature to expect a pivot this year

Our view that inflation will be stickier, leads us to believe that it is premature to expect central banks to pivot this year. We believe that a central bank pivot will not happen before sometime in 2024, but With, however only 1-2 more rate rises to come from the Federal Reserve (Fed) this year, and perhaps 2-3 by the European Central Bank (ECB), we might be approaching the end of the hiking cycle. In our view though, a reversal in interest rate policies is unlikely at this stage in 2023, in our view. Consensus expectations have had to adjust sizeably in the past month, from expecting a reversal in monetary policies by the Fed in H2, to now not factoring in any cuts this year. Our view of no pivot until sometime in 2024 has now become more consensual as a result.

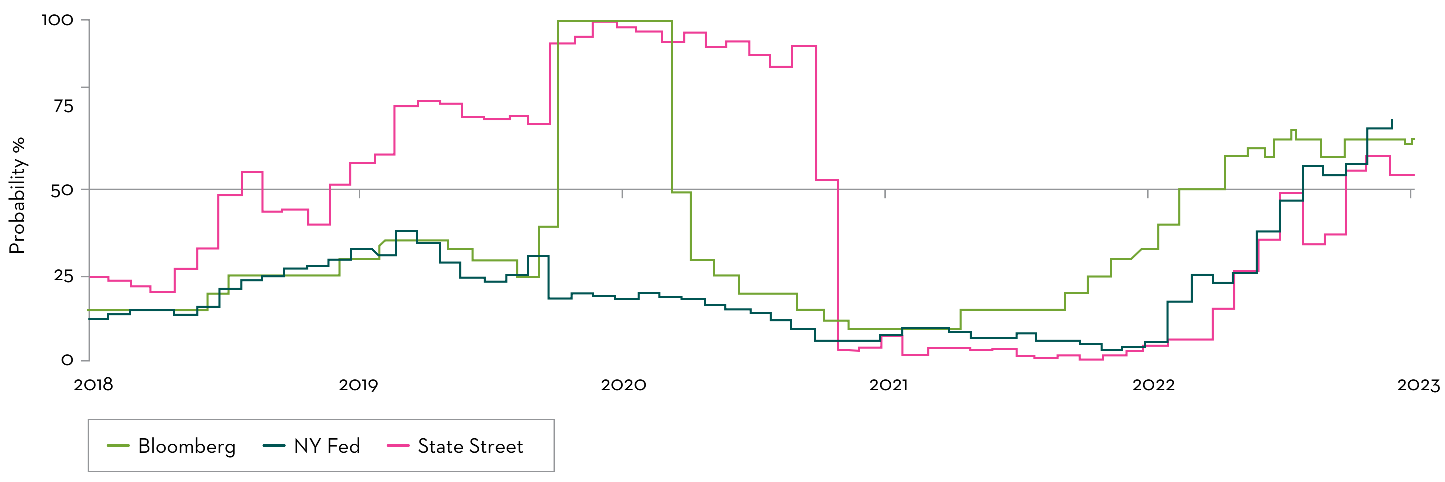
There is a higher likelihood of decoupling in central bank policies between the main western central banks and the People's Bank of China (PBOC). The Chinese central bank has more scope to ease, given the absence of inflationary pressures in China.

Economic cycle: Sharp slowdown rather than economic recession in 2023; though rising risk of recession in 2024

On the macroeconomic cycle, we continue to stick to our core scenario of a 60-65% probability of sharp slowdown at the Global and US levels. With the probability of a recession in the US in 2023 at 30-35% - admittedly this is a somewhat elevated risk, but not our central scenario. So far, economic hard data has been coming in stronger than expected, and the US economy has been more resilient than market forecasts.

Our view that the US might be able to avoid a recession in 2023 is based on the resilience in the economy seen so far, the healthy job market, the still solid private sector balance sheets, and the infrastructure spending related to various government initiatives. In the past we have written why the yield curve might not be as reliable a measure this time round. The yield curves have been inverting in various key geographies for some time now, a typical signal of a recession happening within the following 10 months. We are now getting into one of the most predicted and longest in waiting recession in the US, with such probability reaching 50% in the summer of last year, and over 60% by October/November 2022, and is currently standing at 65% probability (see chart below) – perhaps a bit like waiting for Godot, it might never come!

US recession probability (%)



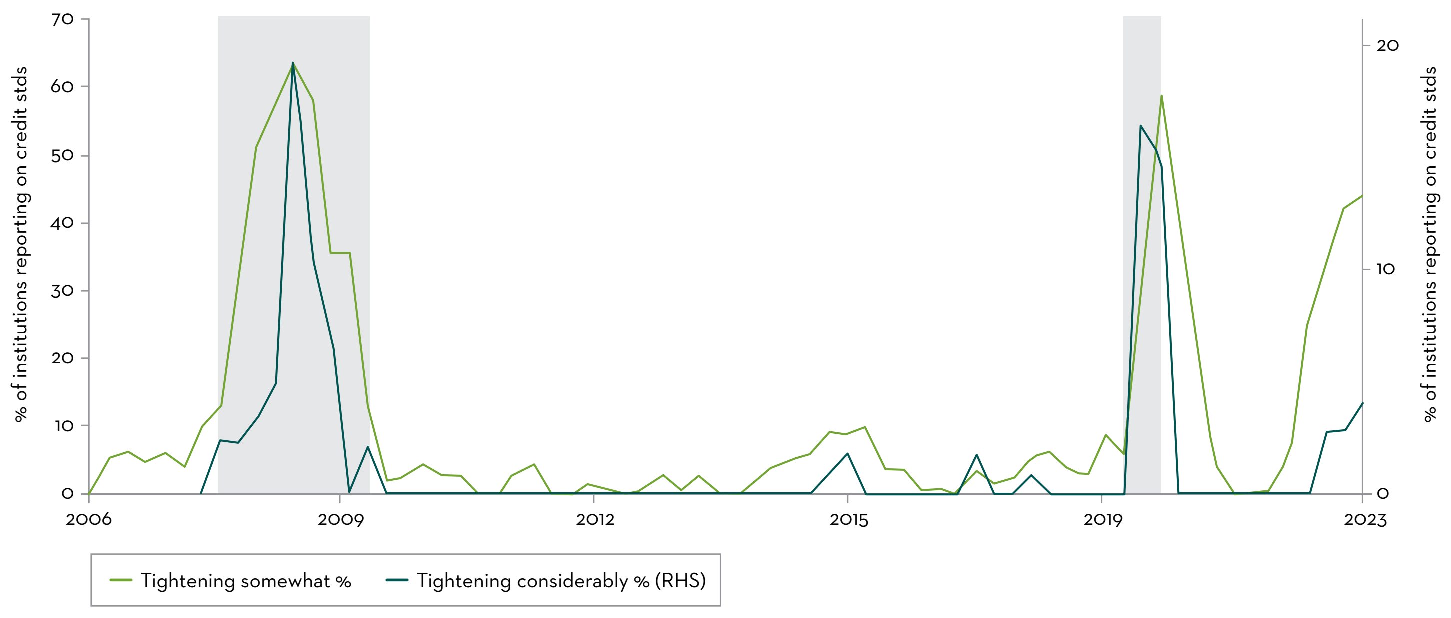
Source: State Street Global Markets and Bloomberg as at 4 July 2023.

We are comforted to be joined by Fed Chair, Jerome Powell, and US Treasury Secretary, Janet Yellen, in our view that the US could avoid a recession this year, although their prediction error could also be elevated.

As we recently wrote, tightening credit lending conditions could risk further exacerbating the economic slowdown, and potentially pushing the US economy into recession. So, it will be important to continue to watch these trends for signs of further tightening conditions. We do reiterate our observation that the curve showing significant tightening in lending conditions is not yet at previous levels that has signalled a recession, as can be seen in the chart below.

Senior Loan Officers Survey

Credit lending conditions for large, middle market & small firms



Source: Refinitiv Datastream, Credit Suisse Research as at May 2023.

*Institute for Supply Management. Also known as ISM Manufacturing Purchasing Managers Index (ISM PMI), is a monthly gauge of the level of economic activity in the manufacturing sector in the United States versus the previous month.

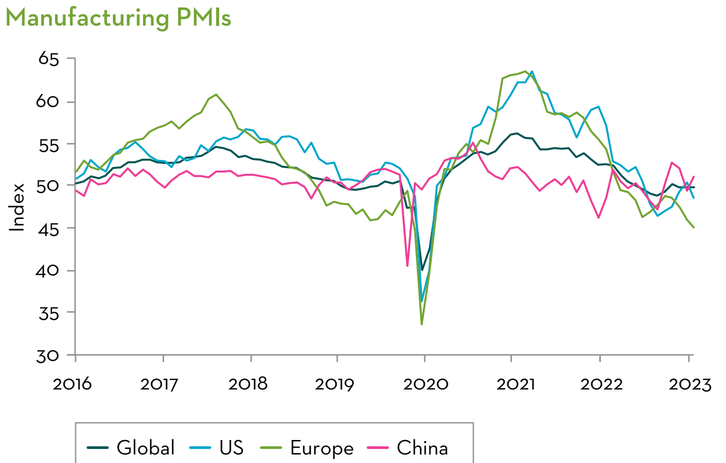
For Europe, we maintain our probability of stagflation at 60-65% – arguably, the region is already in stagflation, as seen from the last GDP datapoints from the region. Within that, we believe that the UK has a high likelihood of recession this year.

For both the US and Europe, the market is now focusing on inverted yield curves once again - the evidence seems to point to a higher risk of recession. We believe that it is not so much about 2023, but rather pointing to an elevated risk of recession in 2024, as the rapid rate rises seen this year take their toll on economic activity, albeit with a lag. Typically it is a 6-18 month lag for interest rates to make their way fully into economic activity. This is what the market might need to worry about next, i.e., another year of no economic growth after a lacklustre 2023, especially if we continue to see steady rate rises from current levels. Which would happen if inflation surprises to the upside.

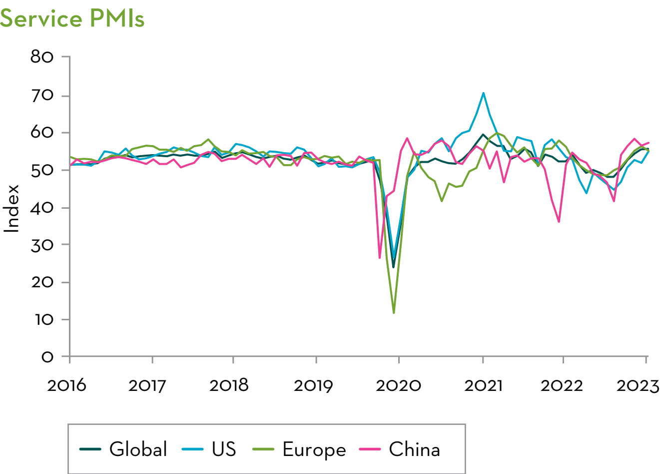
As we recently wrote, tightening credit lending conditions could risk further exacerbating the economic slowdown, and potentially pushing the US economy into recession. So, it will be important to continue to watch these trends for signs of further tightening conditions.

As the second largest economy globally after the US, China remains an important bellwether of the global economic cycle. The sharp and sudden reopening of China from Covid lockdowns at the back end of the 2022 is providing helpful support to the global economic cycle. We expect the Chinese economy to continue to recover in H2, with more of the recovery coming from Services rather than Manufacturing. Services are the more important, and bigger part of the Chinese economy, accounting for c.54% of GDP. This makes it twice as important as manufacturing, which accounts for c.27% of China's GDP.

Manufacturing PMIs



Service PMIs



Source: Martin Currie, FactSet and OECD. as at 30 June 2023.

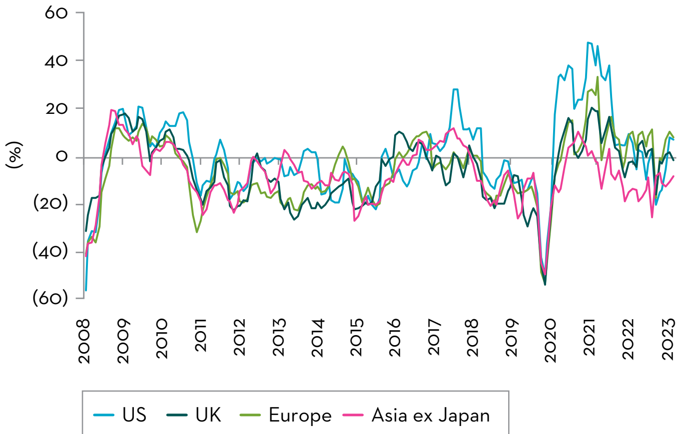
The Chinese Purchasing Manager's Indices (PMI) have been losing some momentum in the past months, as can be seen in the charts above. This is unnerving the markets. However, we believe that, firstly, it is difficult to predict accurately on a month-by-month basis an economy of the size of China coming out of lockdown, and secondly, Services PMIs have remained supportive, well oriented, and remain in expansionary territory. We expect China to account for c.40-50% of the Global GDP growth in 2023. Therefore it remains an important focal point for the rest of the year, and an important determinant of recessionary risk at the global level.

It is worth highlighting, as we have done in the past, as long term investors, predicting a recession might be a futile exercise, given that there are three challenges with predicting such event: (1) timing a recession; (2) timing when the market might be worrying about a recession, and (3) timing when the market might start looking through the recession to the next leg of recovery. Given the challenge with timing these three aspects of market event, we prefer to manage our strategies through the cycle, picking stocks that will be able to withstand a recession, should one occur.

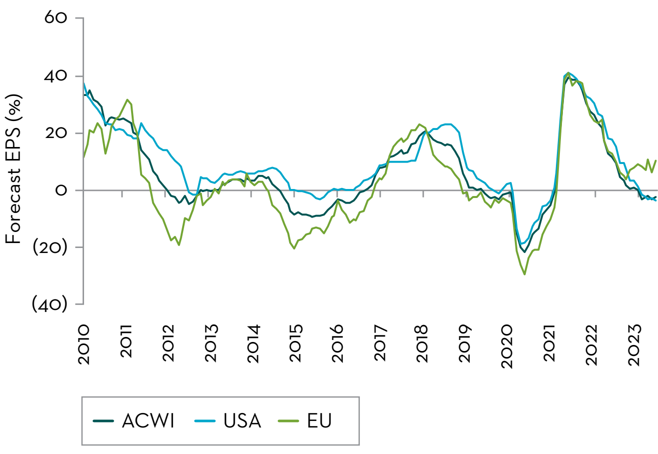
Corporate earnings cycle is in recession

Earnings downgrades have continued to come through since our previous 2023 outlook. Consensus earnings growth expectations are now closer to our own predictions. We leave our top down earnings growth forecasts unchanged, predicting a -1% year-on-year decline in the US, -5% decline in Europe, a +5% growth in Asia, and a 0% growth at the MSCI World Index level. Consensus year-on-year earnings growth for 2023 currently stands at -1% for MSCI World, 0% for MSCI North America, +4% for MSCI Europe, and -3% for MSCI Asia.

Earnings momentum



Forecast EPS growth next 12 months of given equity markets



Source: FactSet and MSCI. Earnings momentum data as at 30 June 2023. Forecast EPS data as at 30 June 2023.

It is worth highlighting, as we observed in our market insights a couple of months ago, that we are seeing some positive inflections in earnings momentum across the Asia and MSCI World levels, and an outright positive earnings revision for Europe and the US. It is too early to call this a trend, as H2 earnings momentum could significantly deteriorate given current headwinds, but this could potentially be supportive for markets if it persists. We do note however, once again, that there is a very wide range of predictions by strategists, with some sizeably negative earnings growth estimates from some of them.

Quality growth style should continue to be more supported in H2 and beyond

In uncertain macroeconomic conditions such as the ones we face, we believe the quality growth style should be supported in H2 of this year and beyond. This uncertainty is due to the broad range of outcomes on inflation, monetary policies, economic cycle and corporate profits cycle, as we have detailed above.

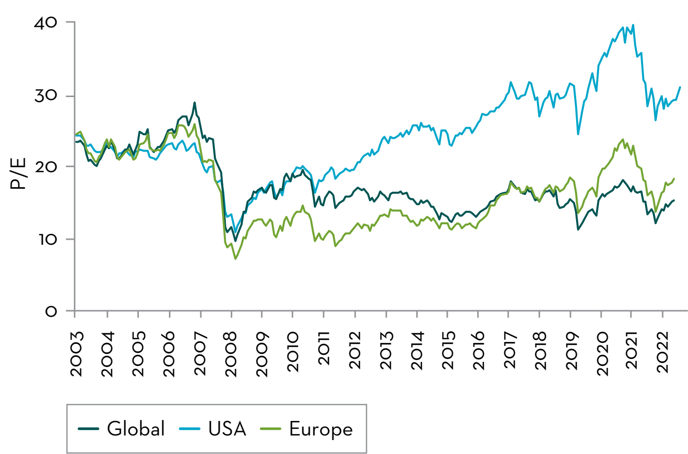
Quality growth stocks, i.e. profitable growth stocks, generating high returns on invested capital, and with strong balance sheets, should fare well in such elevated uncertainty. If inflation remains elevated, these stocks typically have stronger pricing power, and therefore should be able to protect from margin pressure better than other companies. Monetary policies are getting closer to peaking, which means less headwind for long duration stocks such as quality growth. On the macro-economic cycle, if we are heading into a recession, we again believe that quality growth stocks should be able to weather that economic storm better than other companies. Finally, in an environment of corporate earnings recession, where growth becomes more scarce, quality growth stocks, exposed to structural growth opportunities, have a superior growth profile that should make them stand out.

All in all, we believe that it remains important, in such an uncertain environment, to continue to focus on companies with (i) earnings resilience, given the risk of ongoing earnings downgrades, (ii) pricing power, in order to protect margins in this stickier inflation environment, (iii) solid balance sheets, to give better protection in case of recession, and (iv) structural growth opportunities, given the low growth environment.

Equity valuations less supportive following strong year-to-date performance

With markets performing strongly on a year-to-date basis, the valuation attraction in equity markets is less apparent, notably in the US. We continue to see a somewhat more supportive valuation backdrop for European and Asian equities, although a stock specific focus remains critical to finding attractive opportunities, given that the picture is less supportive than it was 6-9 months ago. This is illustrated in the chart below.

Schiller P/E



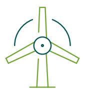
Source: FactSet. Shiller PE as at 30 April 2023, for the USA as at 30 June 2023.

> With markets performing strongly on a year-to-date basis, valuation attraction in equity markets is less apparent, notably for the US market.

It is important to flag that in the first half of the year, US market performance has been very narrow. Focused on what the market perceived to be some of the AI beneficiaries in the technology space. It is also worth reiterating that in such uncertain environment, valuation discipline remains critical for investors.

Mid-term opportunities – Energy Transition, Geopolitical & Technological Fragmentation, and Artificial Intelligence become key themes to focus on

We continue to see opportunities in the eight medium-term thematic opportunities listed below:


Green & Alternative Energy

Electric Transportation – both Electric Vehicles and High Speed Railways

Technological and Geopolitical Fragmentation

Artificial Intelligence, Robotics & Automation

Energy Efficient Infrastructure

Healthcare Infrastructure

Cloud Computing & Cyber Security

Metaverse & Quantum Computing

All of these themes benefit from significant investment support, from the private and/or public sectors of the economy. Some of these investments will be very long duration, making these themes attractive over the long-term investment horizon we focus on. Amongst these eight themes, we believe three are particularly exciting for investors to focus on in the current climate: Energy Transition, as part of tackling the challenges of climate change, Artificial Intelligence (AI), and Technological and Geopolitical Fragmentation. We will detail the latter one in the next section (geopolitics), given this theme's importance to investors as both a source of risk and potential opportunity.

Energy transition, captures the first three themes on our list above, Green and Alternative Energy, Energy Efficient Infrastructure, and Electric Transportation. The second theme of the three in focus, AI, has received a boost in the first part of this year. This has been in part from the excitement triggered by ChatGPT, that has reached 100 million users at the fastest pace of any app historically. Secondly, the outsized earnings beat by Nvidia in Q1, has lead to the market realise that the demand by corporates for AI has been significantly under-appreciated. We believe that the AI focus will remain significant going forward. The potential for AI remains under-appreciated by the market fundamentally, but we are also cognizant, however, that such themes can generate outsized excitement. This can lead to valuations disconnecting from fundamentals. it is therefore critical, as always, to ensure a valuation discipline, based on detailed fundamental assessments.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable. It is not known whether the stocks mentioned will feature in any future portfolios managed by Martin Currie. Any stock examples will represent a small part of a portfolio and are used purely to demonstrate our investment style.

Geopolitics remain the key tail risk event

For the remainder of the year, we continue to see geopolitical risk as the key tail risk for markets. Specifically, the China-Taiwan-US tensions. China's territorial ambitions in the South China Sea are well known and clearly stated, with the US being clear about its intentions to help Taiwan retain its autonomy. The US has also taken significant steps to restrict China's access to leading edge semiconductors technology, and more recently to any microchips that can help keep up in the race towards AI investment.

At the same time, most key regions in the West are keen to reduce their dependence on Taiwan for leading edge semiconductor technology, as currently 90% is supplied by Taiwanese companies to the rest of the world. The US is subsidising a Taiwan Semiconductor Manufacturing Corporation (TSMC) plant on its territory, as is Japan, and we believe that Europe will likely be following suit soon. Arguably, this drive to diversify the sourcing of semiconductors is happening 10 years later than it should have.

Tensions on the geopolitical front are clearly leading to technological fragmentation, one of our key medium-term key themes listed in the previous section. This constitutes one of the most sizeable risks to financial markets in our view. Henry Kissinger appears to have recently predicted that it will be inevitable for China and US to enter into an armed conflict over Taiwan. Whilst we hope that his prediction proves wrong, it is unnerving to hear it come from such a politically savvy commentator. We find it important to acknowledge this as a significant risk, with many potential negative implications for financial markets. Status quo on this front might end up being the best outcome for financial markets.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable. It is not known whether the stocks mentioned will feature in any future portfolios managed by Martin Currie. Any stock examples will represent a small part of a portfolio and are used purely to demonstrate our investment style.

Risks for investors remain unchanged, but some are more critical to focus on

The risks we listed as part of our 2023 outlook remain relevant, and are unchanged. Others, notably inflation risk, are more important to focus on as this will dictate the monetary policy cycle, which in itself will have an influence on the economic cycle. We list these risks below, with a short rationale:

Key risks to watch out for in 2023

Monetary policy risks – the over-tightening of interest rates can lead to a higher risk of policy mistakes, impacting both markets and economies, and potentially increasing stress points in the banking sector

Fiscal policy risks – lack of follow through in stated government infrastructure spending programs could put more downside risk to economic momentum

Persistence in inflation – given the difficulty of predicting frictional inflation, the risk of stronger and longer lasting inflation could fuel a need for more tightening in monetary policies

Pandemic relapse risk – localised lockdowns could cause further disruptions in supply chains and create bottlenecks, in turn leading to shortages, further fuelling frictional inflation

Corporate Margins pressure – more persistent and more elevated inflation could lead to increased corporate margin pressure for companies lacking pricing power

Market volatility and Style leadership volatility – shifting expectations in monetary policies could lead to ongoing volatility in markets, and in style leadership between Growth and Value styles

Lower long-term growth – growing indebtedness is likely to lead to ongoing low long-term growth in our view, with more scarcity in growth opportunities

Higher taxation – given higher indebtedness, there is a high likelihood of higher tax rates, both for households and for Corporates

Geopolitical risks flare ups – Russia-Ukraine conflict tragically materialised in 2022 with the risk of the conflict broadening. Other geopolitical hotspots to watch out for are China-Taiwan, North Korea, Iran-Israel, and China-RoW. Some of these geopolitical risks will be military, others will materialise into technological conflicts, such as China-US

Climate disasters risk – climate change related disasters are likely to continue to take their toll on various regions, not only negatively impacting societies, but also corporates in terms of the risk to both productive capacities and assets in general.

Waiting for Godot – a sharp slowdown, rather than a recession

Overall, we conclude stating that whilst our predictions for the remainder of 2023 have not changed compared to what we wrote at the end of last year, it has already been a very eventful first half. Forecast risk has been exacerbated by some events such as the US regional bank failures experienced in H1, tense negotiations around the US debt ceiling to avert a US government debt default, and the growing geopolitical risks.

We continue to predict a market that will be fearful of recession risks, but we will continue to work on the basis of a sharp slowdown rather than a recession for 2023. We do however believe that 2024 might be the year where a recession finally materialises at the economic level. 2024 is also likely to be the year where central banks pivot, as a result of increasing recession risk, which in itself could provide some additional support for equity markets.

Wishing our readers an enjoyable summer.

Zehrid "Zed" Osmani

Head of Global Long Term Unconstrained Equities
& Senior Portfolio Manager

2024 is also likely to be the year where central banks pivot, as a result of increasing recession risk, which in itself could provide some additional support for equity markets.

Important information

This information is issued and approved by Martin Currie Investment Management Limited ('MCIM'), authorised and regulated by the Financial Conduct Authority. It does not constitute investment advice. Market and currency movements may cause the capital value of shares, and the income from them, to fall as well as rise and you may get back less than you invested.

The information contained in this document has been compiled with considerable care to ensure its accuracy. However, no representation or warranty, express or implied, is made to its accuracy or completeness. Martin Currie has procured any research or analysis contained in this document for its own use. It is provided to you only incidentally and any opinions expressed are subject to change without notice.

This document may not be distributed to third parties. It is confidential and intended only for the recipient. The recipient may not photocopy, transmit or otherwise share this [document], or any part of it, with any other person without the express written permission of Martin Currie Investment Management Limited.

This document is intended only for a wholesale, institutional or otherwise professional audience. Martin Currie Investment Management Limited does not intend for this document to be issued to any other audience and it should not be made available to any person who does not meet this criteria. Martin Currie accepts no responsibility for dissemination of this document to a person who does not fit this criteria.

The document does not form the basis of, nor should it be relied upon in connection with, any subsequent contract or agreement. It does not constitute, and may not be used for the purpose of, an offer or invitation to subscribe for or otherwise acquire shares in any of the products mentioned.

Past performance is not a guide to future returns.

The distribution of specific products is restricted in certain jurisdictions, investors should be aware of these restrictions before requesting further specific information.

The views expressed are opinions of the portfolio managers as of the date of this document and are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. These opinions are not intended to be a forecast of future events, research, a guarantee of future results or investment advice.

The information provided should not be considered a recommendation to purchase or sell any particular strategy / fund / security. It should not be assumed that any of the securities discussed here were or will prove to be profitable.

It is not known whether the stocks mentioned will feature in any future portfolios managed by Martin Currie. Any stock examples will represent a small part of a portfolio and are used purely to demonstrate our investment style.

Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
- The strategy may invest in derivatives Index futures and FX forwards to obtain, increase or reduce exposure to underlying assets. The use of derivatives may result in greater fluctuations of returns due to the value of the derivative not moving in line with the underlying asset. Certain types of derivatives can be difficult to purchase or sell in certain market conditions.

For wholesale investors in Australia:

This material is provided on the basis that you are a wholesale client within the definition of ASIC Class Order 03/1099. MCIM is authorised and regulated by the FCA under UK laws, which differ from Australian laws.

Martin Currie Investment Management Limited, registered in Scotland (no SC066107)
Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300), 2nd Floor, 5 Morrison Street, Edinburgh EH3 8BH

Tel: (44) 131 229 5252 Fax: (44) 131 222 2532 **www.martincurrie.com**

Both companies are authorised and regulated by the Financial Conduct Authority. Martin Currie Inc, 280 Park Avenue New York, NY 10017 is also registered with the Securities Exchange Commission. Please note that calls to the above number and any other communications may be recorded.

© 2023 Martin Currie Investment Management Limited.