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Principal Asset Management℠

A new investment era?

Portfolio construction in a slowing economic environment

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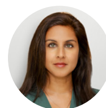

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Stimulus from global central banks has been a hallmark of the investment landscape since the Global Financial Crisis (GFC). In 2008, before the GFC had started, the four largest global central banks had a total of $6.5 trillion of assets on their balance sheets. By 2019, the G4 balance sheets had almost doubled to $12 trillion—and just two years later, in 2021, they had doubled yet again to $26 trillion!

The decade following the GFC was a golden period for investors, as central banks aggressively expanded their balance sheets in order to stimulate the economy. In fact, just owning the S&P 500 delivered a 16% per annum compound annual return from 2013 all the way through 2021. However, the golden period ended abruptly in 2022 as global central banks started to aggressively raise policy rates and shrink their balance sheets, moving decisively away from ultra-easy monetary policy in an attempt to combat surging inflation.

The reversal in global central bank policy has led to an almost unrecognizable global investment landscape. Unlike the golden era of the past decade where low inflation and low interest rates were suppressing volatility and lifting asset prices, it seems possible that higher inflation and higher interest rates will be the primary forces dictating market dynamics in the decade ahead, irrespective of economic growth. Investor behavior will need to adjust: Expectations for returns need to be lowered, expectations for volatility need to be raised and, above all, additional investment discipline will be required.

At the onset of what is likely a new investment era, reallocating to address key risks will be crucial to potential outperformance. Investors today would be well suited to ensure their exposures to market, systematic and implementation risks allow them to take advantage of market inefficiencies and to minimize vulnerability to macro-driven threats:

Market	
Equity risk	Decrease
Interest rate risk	Increase
Alternatives beta	Increase
Currency risk	Neutralize

Systematic	
Equity factor risk	Avoid
Credit risk	Offset
Inflation	Mitigate
Liquidity	Decrease

Implementation	
Idiosyncratic selection risk	Increase
Manager tracking error	Increase

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A new investment era?

Market risks

Reduce equity risk

Equity markets may have started 2023 well, but that may prove to be temporary respite. In 2023, not only are further rate hikes expected, but the Federal Reserve (Fed) is unlikely to deliver any rate cuts even as the economy falls into recession. As a result, markets will start shifting their attention to the next serious concern: Earnings recession. A conservative Principal Asset Allocation model points to an earnings contraction in 2023—a headwind that will, inevitably, renew and extend the equity market drawdown with the S&P 500 potentially re-testing its September 2022 lows.

Increase interest rate risk

After a particularly tough 2022, U.S. 10-year Treasury bonds now yield more than twice the estimated dividend yield of the S&P 500 Index. This presents investors with the opportunity to lock-in income with a less volatile asset. Additionally, with yields having risen, inflation slowing, and central banks closer to the end of their hiking cycle, bonds are positioned to provide risk mitigation during the coming economic slowdown. The negative correlation between stocks and bonds has reasserted itself, and the diversification benefit of fixed income has been restored.

Increase alternative beta

Alternatives have strong defensive characteristics which are important in today's macro environment. In addition, they offer diversification benefits against traditional equity and fixed income. Not only do real assets, such as commodities and natural resources, offer inflation mitigation characteristics, but other alternative investments such as listed infrastructure provide stability of cash flows and exposure to the structural de-carbonization trend.

Neutralize currency risk

Central banks are entering a phase when markets are anticipating policy pivots, while resilient economic growth in certain segments of the globe are prompting questions about relative economic strength. Against this backdrop, sudden and inexplicable large movements between currencies are possible. Ultimately, given the already elevated volatility that the inflation and interest rate outlook will create, investors may want to focus on market risks they have a degree of confidence in and avoid the outsized, unintended negative risk that currency movements could bring.

Systematic risks

Avoid equity factor risk

Multi-factor investing was very mixed in 2022 with the difficult macro conditions making it tough to pick winners and losers. This year, there appears to be no obvious trend for growth versus value due to the unusual slowing growth/high policy rates combination. Similarly, the large- vs. small-cap story is unclear given contradictory signals from fundamentals and valuations. In fact, mid-cap equities offer to bridge the gap between small- and large-cap equities, not only trading at a meaningful discount to large-caps, but their greater defensive sector exposure also means mid-caps are less vulnerable than small-caps to the tough economic backdrop.

Offset credit risk

With the days of cheap funding and abundant liquidity firmly in the past, and the economy slow-walking into recession, riskier credit segments will likely see fairly significant spread widening during 2023. Dialing down spread risk should be offset by increasing exposure to core fixed income, such as government bonds, investment grade, securitized debt. Not only should they have sufficient buffer to weather the storm, they are also now offering more attractive yields than in recent years.

Mitigate inflation risk

Until 2021, inflation had remained so low across the global economy that investors hadn't needed to consider including inflation mitigating assets in portfolios. But now, with inflation unlikely to decelerate sufficiently to reach central bank targets this year, and potentially even re-surge if labor market supply-demand conditions remain so tight, inflation mitigation has become a defining portfolio trait. Asset classes which have a positive relationship to inflation, such as commodities and infrastructure, should sustain strong performance throughout this year.

Decrease liquidity risk

The tightening of financial conditions is removing the easy access to capital and, as a result, liquidity risk has increased over the past year, posing risks to financial stability. This has recently been underscored by the stress in the UK government bond market which required the Bank of England to intervene in order to avoid a national pension crisis. Prioritizing exposure to asset classes that can be liquidated easily in the event of spiking systemic risk concerns is advised. Equally, exposure to liquid assets can also enable a swift increase in exposure to riskier assets as valuations become more attractive and conditions eventually improve.

Implementation risks

Increase idiosyncratic selection risk

Without easy monetary conditions to lift the broad market and economic weakness likely to make conditions very challenging during 2023, manager selection in this environment is of increased importance for investors. Managers who, instead of trying to bet on a market or an industry, understand company specific components and are able to distinguish winners from losers based on core strengths, balance sheets, and exposure to important structural trends, will likely yield favorable results in this environment.

Increase manager tracking error

In this environment, with interest rate and economic growth risks stacking up, investors may believe it is better to hug the benchmark. Yet, the opposite is true. Now is the time to focus on managers that have strong views and conviction and are willing to increase active risk where they can be rewarded to do so in order to capitalize on market inefficiencies. When markets are challenging, that is the time to focus on true issue selection and increased budget for manager alpha.

› PORTFOLIO IMPLICATIONS

The investment landscape today is much changed from the golden era of the last decade. With central banks no longer carrying all asset prices higher, investors need to thoughtfully reconsider their portfolio construction process and reallocate their risks to both take advantage of market inefficiencies and to minimize exposure to macro-driven threats. This new era is one where strong conviction and deep understanding of company and sector will be prized, and outperformance will be driven by discipline, diversification and active management.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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