January 2023

The Top Trends of 2023

We have a sense that global investors are frozen in the headlights of rising inflation and interest rates. They know deep down what is coming, that the impact will be large, but they can't bring themselves to move. Many seem to be hoping that the hit will never come, the next recession will be short and shallow, interest rates will fall again. To a surprising degree, they are still allocating funds to assets that worked when money was easy, including tech and private equity.

We are not. We think that even as inflation falls, the new normal is more like 4 percent than 2 percent. Rates will not fall back to anywhere near zero. A new era will bring new winners and losers in the market. Here are five of the ways we see tight money changing the world in 2023.

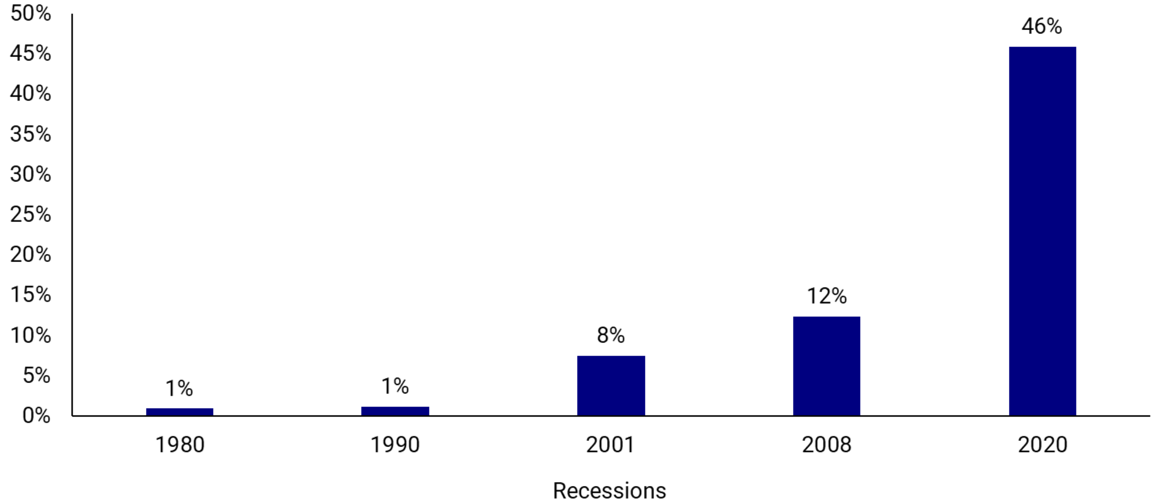
Long Grind

In the easy money era, investors grew accustomed to ever more government rescues in each successive recession—as chart 1 shows. The consensus now is for a mild and short recession that starts in the second half of 2023 and lasts, at most, six months.

But all this assumes inflation fades away, which is unlikely. Corporations feel a sense of pricing power they haven't enjoyed in decades. Service prices are still rising. Attitudes about work are changing, in ways that will push wages upward. One in eight workers who quit during the pandemic do not plan to return. Others aim to return only part time.

Stickier inflation will make it harder for central banks to cut rates to counter the next recession, which may grind on longer than expected.

Chart 1. G4 total stimulus including off-balance sheet stimulus
(Percent of GDP)



Source: Haver, IMF, UBS, Breakout Capital Calculations. Note: Estimates include off-balance sheet stimulus including central bank purchases, credit commitments and other subsidies

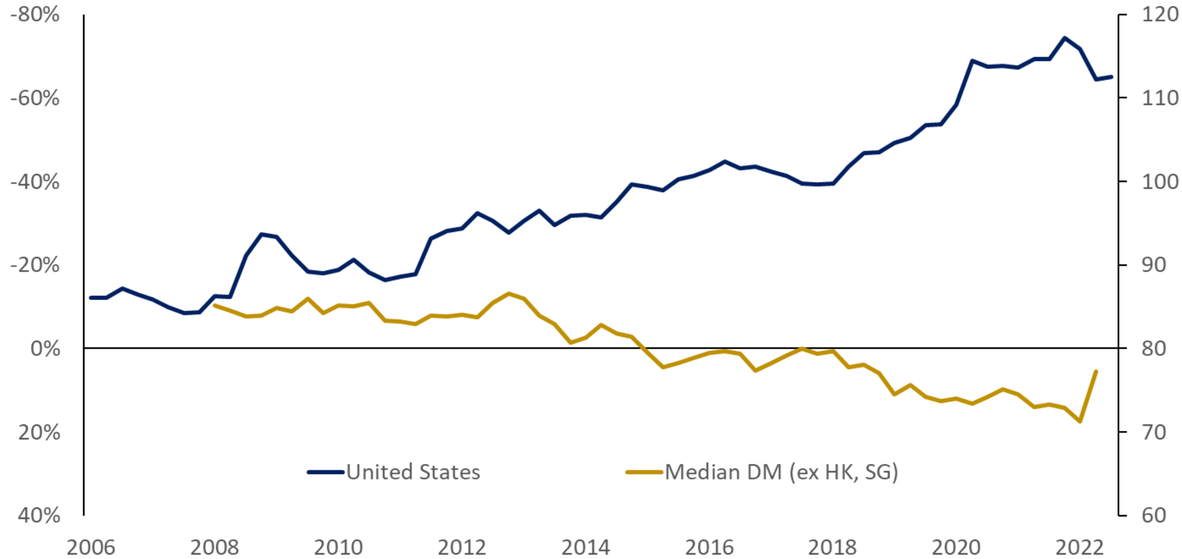
Peak Dollar

Quietly, and despite recent upward moves, the dollar has been drifting downward since October. At that point it had been rising for more than 11 years, four years longer than in the last two major bull markets going back to 1970. It had peaked at a level—20 percent above its long term valuation trend—that has typically signaled multi-year declines, also going back to 1970.

The fundamentals point to further decline as well: relative to other developed nations, the US is expected to grow more slowly, and US interest rates are expected to rise less rapidly in 2023.

When do currencies lose long-term momentum? Often, when the rest of the world loses trust that the issuing nation can cover its debts. US debts to foreign nations, reflected in its net international investment position, have not only been rising at an astonishing pace, they have been rising while the debt burdens of other developed nations have been falling (see chart below). That makes the US more vulnerable than most in a tight money era.

Chart 2. Net International Investment Position
(Percent of GDP, inverted index)

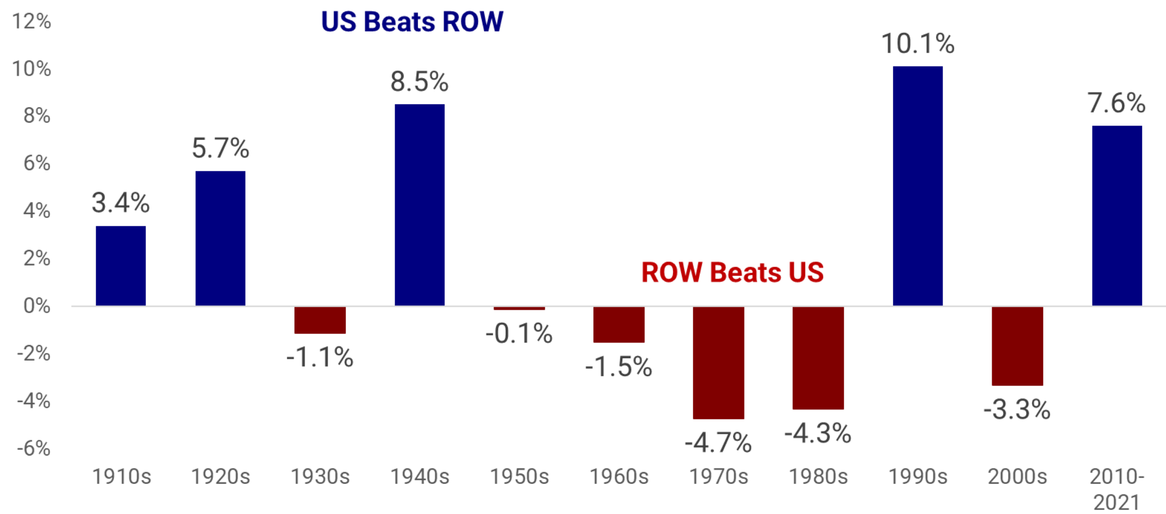


Source: Bloomberg, Haver, Breakout Capital Calculations

Rise of the ROW

The frozen minds of many investors find it hard to imagine money flowing anywhere other than the United States which—as some argue--has been the top-returning stock market of the last century. But no one invests for the next century. In six of the 11 decades going back to 1910, which is to say slightly more often than not, the rest of the world (ROW) has outperformed the United States (see chart below). Now, the United States accounts for a record 60 percent of global stock market value, which makes another upward move less probable than many expect. More likely, the 2020s belong to the ROW.

Chart 3. Average annual stock market returns by decade, US v Rest of World
(Annualized, Percent, Real Returns in US dollar terms)



Source: Source: Credit Suisse, DMS Database 2022, Copyright © 2022 Elroy Dimson, Paul Marsh and Mike Staunton
Note; ROW = Rest of World

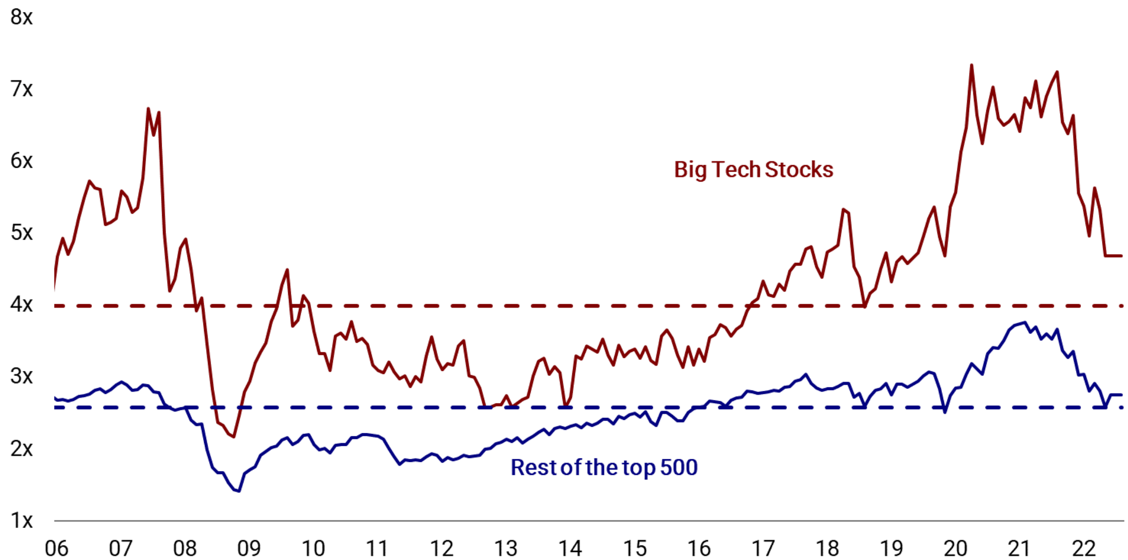
Big Tech Shrinks

To many people, not just investors, it is also hard to picture a world not dominated by the big American tech companies which became synonymous with internet services in the last decade. But churn is the norm, especially in tech. Companies that rise into the global top 10 by market cap in one decade almost always fall out the next. By the end of the 2010s, seven tech companies were in the top 10; already two of them have fallen out.

The five remaining (all American) are under challenge from the law of large numbers, regulators, competitors, and antiquated models. Providing internet search, shopping, streaming or social media services now looks very 2010s.

While easy money encouraged bets on big, expensive growth stocks, that bias is fading in the new tight money era. Despite the hit big US tech companies took in 2022, their valuations still look expensive compared to their own past, and the rest of the market (see chart below). They likely have farther to fall.

Chart 4. Big Tech vs rest of S&P 500: Valuation Multiples
(Ratio)



Source: Goldman Sachs: Big tech Includes Apple, Google Amazon and Microsoft
Note: The chart plots EV/sales as the valuation multiple. EV: "company value" * as multiple of sales

Privates Retreat

In the last decade public stock markets tripled in value worldwide, but private markets rose 11-fold. Taken together private funds, covering assets from stocks to real estate and debt, are worth around $10 trillion and there has been no sign of a let up, yet. Private investments have become popular vehicles for avoiding regulatory scrutiny and, now, dodging the need to recognize losses in the current bear market. They cannot, however, hide indefinitely.

The exit doors are closing on private fund managers, as the market for IPOs dries up. The prices private firms get for the companies they sell has been plummeting. Meanwhile the privates are particularly vulnerable to tight money: the typical publicly traded company has debt two times its earnings, compared to five times for privately owned companies.

Private firms did manage to wait out the worst of recent recessions before reporting results, which meant they never had to disclose the full depth of their losses. But that won't work if the next recession proves to be a long grind.

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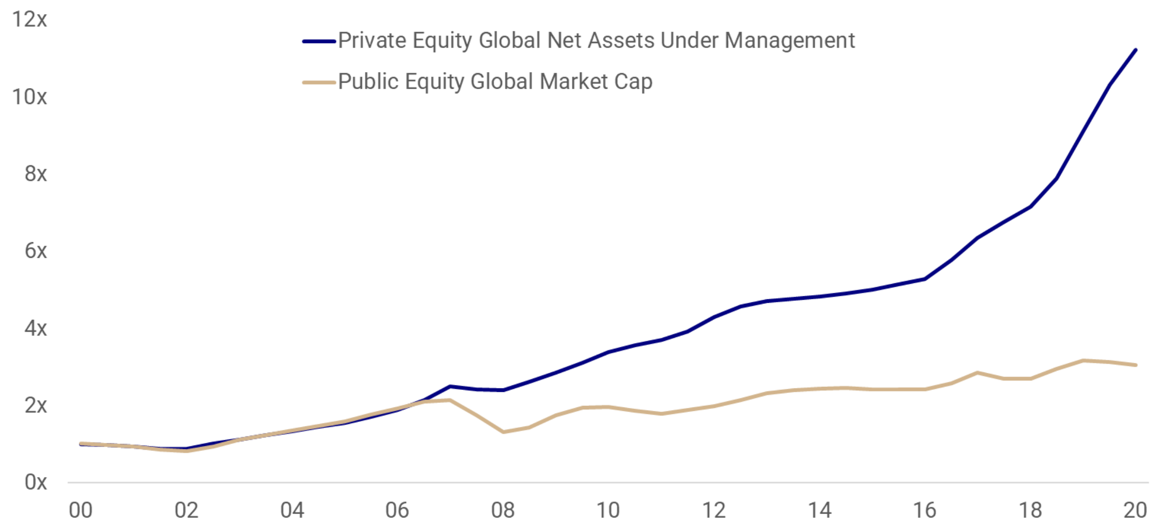
Chart 5. Market size, indexed to 2000 value
(Index)



Source: McKinsey & Company, “McKinsey Global Private Markets Review 2022,” published March 2022

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