

2023 Multi-Asset Outlook: It's not just equity versus fixed income

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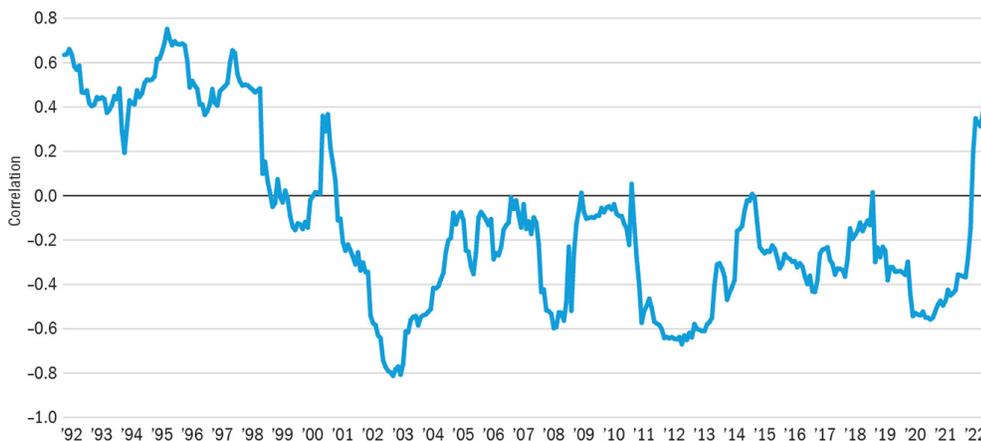
Markets could be headed back to normal, with a slightly “new normal.”

The multi-decade relationship between stocks and bonds broke down in 2022, posing unique challenges for the performance of multi-asset portfolios. Will we have a return to normal in 2023, and what will this mean for stocks and bond allocations? Here are my thoughts:

Equity/bond correlations will become negative again once inflation is under control

The positive correlation between stocks and bonds in 2022 is not unprecedented in the context of modern market history. And while these positive correlations will likely continue into 2023, investors should expect a return to negative correlations — stocks and bonds moving in opposite directions — when markets are convinced inflation is under control. I think that the changing nature of correlations underscores the need for investors to think about risk allocation in multi-asset portfolios instead of relying solely on capital allocation.

- ▶ **Although stocks and bonds have moved together in the past, this has been uncommon in recent history**



Source: Columbia Threadneedle Investments, Bloomberg L.P. Correlation between stocks, as represented by the S&P 500 (which tracks the performance of 500 widely held, large-capitalization U.S. stocks) and 10-Year Treasury Yields from 1992 through Sept. 30, 2022. It is not possible to invest directly in an index.



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Diversify within, instead of between, asset classes

The possibility of a recession and elevated inflation makes “traditional” asset allocation decisions — stocks versus bonds — more complicated. Instead of choosing between asset classes, I think that there are interesting opportunities for investors within asset classes. For example, within U.S. equity, small cap appears more interesting versus large heading into 2023. Small caps have greater exposure to domestic revenue and could outperform, especially when we think about the relative strength of the U.S. economy versus other regions. If you’re a global investor, there could be compelling valuation opportunities in emerging markets relative to developed markets — particularly in Europe, where the war introduces greater uncertainty. Within fixed income, I think that high yield may have greater risk than areas like investment grade or securitized. For this reason, you need to be sure that you have an active approach to identify resilient companies.

This environment calls for being active within multi-asset portfolios

Companies and consumers that are not well-positioned for a downturn will struggle in a more challenging economic environment. There’s an opportunity to leverage true fundamental analysis and look around for buying opportunities — whether it’s a stock or a bond that has been beaten up in a more general market slide. Rather than big asset class bets, it will become much more important to check under the hood within each asset class to identify robust sources of alpha.

Look beyond stocks and bonds

During the first half of 2022, commodities seemed to be the only place investors could hide from broad-based market declines. We could continue to see commodity strength with supply chain issues and geopolitics impacting oil prices. Although, we also need to be mindful of the impact of global growth on commodity prices. Non-directional alternative strategies have done well this year relative to traditional stocks and bonds, and have finally earned a more relevant place in investors’ portfolios.

Markets will go back to normal, with a slightly new normal

Back to normal for asset allocation means a return to diversification between stocks and bonds, and expectations of positive returns for both asset classes over the medium-to-long term — even if we’re starting at dramatically higher interest rates. This is good news for multi-asset portfolios, which really struggled in 2022, as correlations between stocks and bonds turned positive. But I also think we’ll have a new normal that involves being more selective within these allocations.

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