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2023 outlook: The good, the bad and the unknown

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For all the gloomy talk about the economy in 2023, stabilizing interest rates could be a bright spot for investors. But with imbalances lurking in the shadows, 2023 could be the year for higher-quality bonds, select large- and small-cap stocks, and private-market investments.

Highlights

- **The good:** The end of the rate-hike cycle may be in sight, letting markets focus more on economic fundamentals.
- **The bad:** The Eurozone appears to be headed for a recession, whereas the US is slightly less at risk.
- **The unknown:** The markets are hunting for imbalances, such as whether China's return to growth will be stymied by its significant debt burden.

Investors can be forgiven for wanting to put 2022 in their rearview mirrors. High inflation, rate hikes, market volatility, the war in Ukraine and continued Covid top the list of things we'd just as soon forget. Will 2023 bring more bad news or do investors have reasons for optimism? Let's take a sneak peek at the good, the bad and, if not the ugly, then at least the unknown.

The good: The Fed may pause as rate hike cycles near an end globally

Expect less market volatility tied to interest rates

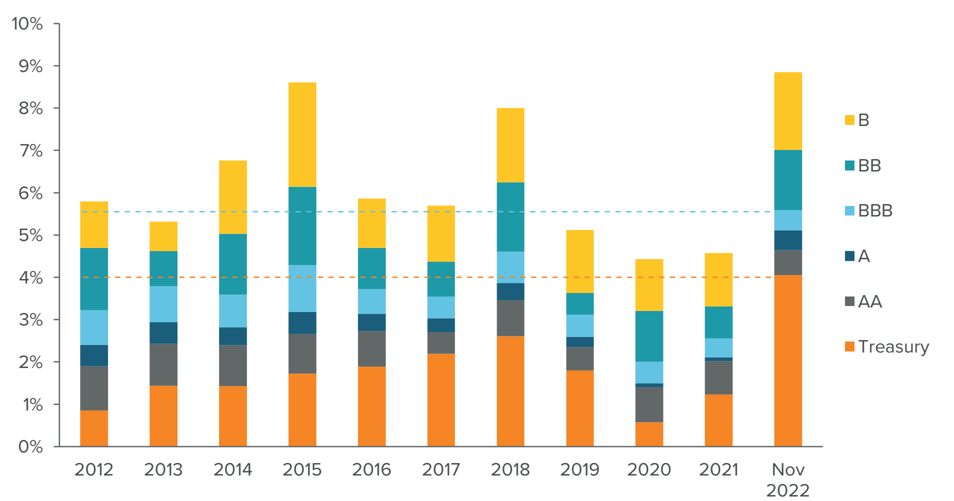
As central banks get a little less hawkish, markets will focus less on rates and more on the economy — which unfortunately includes the risk of recessions scattered around the globe. That said, central banks are likely to head in separate directions as the hiking cycle ends, driven by local differences in growth and inflation. The European Central Bank may focus on encouraging economic growth, since the Russia-induced energy price shock isn't in their control. In the US, easing inflation pressures should allow the Federal Reserve to halt the rapid rate rise, but don't expect rate cuts until labor markets rebalance.

High-quality income-producing assets are a great place to be

Positive real interest rates point to a better risk/reward relationship for fixed income investors (see chart). Compared with higher-yielding bonds, we generally favor investment-grade corporate bonds, which are in lighter supply and tend to have solid fundamentals. We're also finding attractive value in securitized credit, including agency mortgage-backed securities and asset-backed securities (particularly bundled car loans and credit cards).

US Treasury bonds now yield as much as below investment grade bonds did at the end of 2021.

A silver lining for bond investors: More yield for less risk



At 11/30/22. Source: Bloomberg Index Services Limited and Voya Investment Management. Treasuries represented by the Bloomberg US Treasury Index. Yields by credit quality represented by the Bloomberg US Corporate Aa, A and Baa subindices and the Bloomberg US High Yield Corporate 2% Issuer Cap Ba and B subindices. The blue dashed line represents the US Treasury Index yield as of 11/30/22 and the yellow dashed line represents the Bloomberg US Corporate Baa Index yield as of 11/30/22.

Equity market volatility is creating opportunities in US large caps

Given the big questions about the resilience of global economic growth in the coming year, it's hard to imagine there will be enough corporate earnings growth to drive a sustained rally in equity markets. Investors will have to hunt for opportunities. Larger corporations may be better positioned to withstand today's economic headwinds, in part thanks to their more durable revenue streams and ability to control costs. Small-cap stocks are enticing for other reasons, including their 40% price-to-earnings discount to their large-cap counterparts — the biggest gap since 2003.[1]

The bad: A mild US recession is likely but not inevitable

> The lack of significant imbalances should help the US economy avoid a serious downturn.

Global growth is under pressure on multiple fronts

The cumulative effects of central bank tightening, disruption in the energy supply and the fading impact of Covid stimulus will push global growth below potential and threaten recession in several key economies — particularly in the Eurozone. While the probability of a US recession is high, we don't anticipate that economic growth will drop suddenly. This is in part because we don't see significant imbalances in either the corporate or consumer segments. Corporate balance sheets are merely cooling from their very strong positions, and consumer spending is still supported by excess savings left over from various Covid stimulus packages.

If a recession happens, it will be a painful experience for many people. But from an economic perspective, it will be a necessary medicine to ensure the healthy functioning of an economy. A side effect will be higher unemployment, driven by the decrease in demand for labor. But on the flip side, companies have been struggling to recruit skilled talent, which could cause many of them to hold onto workers in a downturn. The persistent shortfall in the labor supply should keep the unemployment rate from going too high, too quickly.

Inflation is still uncomfortably high

In Europe, fiscal policy that subsidizes high energy costs will combine with low unemployment to support consumer spending, resulting in persistent core inflation. Inflation has peaked in the US, but the slow adjustment of the labor market will keep wage pressure elevated and inflation above target throughout 2023.

The unknown: Markets are looking for imbalances

Watch out for financial market disruptions

The speed of interest rate hikes has been swift and unrelenting, increasing the strain on the markets. Housing has fallen, crypto is in crisis, and the September rout in the UK government bond market forced many UK pension plans to offload assets. Are other imbalances out there, waiting to hit the markets?

- As China eases its harsh Covid lockdown policy and reopens its economy, the markets will watch the balancing act between two forces. One is how much China will be able to increase global supply and demand. The other is whether this key engine for global growth will be limited by its significant debt burden.
- Some market segments have developed a significant reliance on low to negative real interest rates and the persistent flow of low-cost financing. As this "cheap" money is withdrawn in the face of an economic slowdown, we could see a notable market disruption. Though not systemic, such a disturbance would put components of the commercial real estate and leveraged finance markets will be under the microscope in the year ahead.

[1] As of 09/30/22. Source: FTSE Russell, Voya Investment Management. P/E: Trailing 12-month price/earnings ratio, based on the Russell 2000 Growth Index (small cap) and Russell 1000 Growth Index (large cap). **Past performance is no guarantee of future results.**

- The financial markets are currently anticipating that the Fed will need to reverse course and cut rates in the second half of 2023 — an expectation that has fueled the late-2022 market rally. But what if the Fed makes slow progress fighting inflation? Or what if the recession everyone is expecting doesn't materialize? The markets would likely start worrying that the Fed may keep rates higher for longer, and that could drag down valuations.

Takeaways: Top fixed income, equity and alts ideas

- **Fixed income:** Consider investment-grade corporate bonds, high-quality agency mortgage-backed securities and asset-backed securities. These higher-quality assets stand to benefit if interest rate volatility levels fall below where they currently stand — which is at an extremely elevated level compared with equity and currency market volatility.
- **Equities:** With headwinds to both earnings growth and market multiples, we struggle to see a sustained rally in the equity market in 2023. But there are still opportunities out there. Look for select large caps with strong enough earnings to help them withstand prolonged periods of economic headwinds. Certain heavily discounted small caps and income-oriented strategies are attractive as well.
- **Private markets:** In times of extreme market stress, private markets — both equity and credit — and other alternatives offer low correlations to stocks and bonds. Periods of increasing economic uncertainty have also historically provided some of the best years for private investments.

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