

Morgan Stanley

INVESTMENT MANAGEMENT

2023 Investment Outlook

INSTITUTIONAL INVESTORS

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2023 Investment Outlook

Institutional Investors

Applying the Lessons of a Turbulent Year to 2023

A confluence of unprecedented events in 2022 weakened asset prices across all markets. Rarely have investors had to grapple with the kind of lessons imparted by a global economy just starting to emerge from a pandemic, while dealing with unprecedented monetary policy measures and a major land war in Europe.

The turbulence of 2022 now weighs heavily on our investment outlook for 2023, with implications ranging from economic growth, inflation, central bank policy and interest rates to credit quality, earnings, valuations, investor sentiment and other key metrics.

We aim to help identify the portfolio implications for our clients, and offer investment solutions to meet their unique objectives and guidelines. While 2022 may have delivered more than its share of disruptions, our investment philosophy remains constant. As always, we seek to:

- capitalize actively on the opportunities presented by volatile investor sentiment
- ensure that portfolio risk profiles are appropriate for our investment strategies
- pursue fundamental value that helps build client wealth over the course of many business cycles
- take dynamic action that serves the long-term interests of our clients, yet remain steadfast when patience is warranted

In this 2023 outlook, our investment managers share their diverse views on where markets are headed and how they are positioning their strategies. We hope you find the discussions informative, and we wish you a healthy and prosperous New Year.

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EQUITY



Andrew Slimmon
Head of Applied
Equity Advisors

We See A Resilient Economy Without a Looming Collapse

KEY POINTS

- 1 In our view, the first quarter of 2023 has the ingredients to build on strengths of the fourth quarter of 2022.
- 2 An inverted yield curve hints at a potential economic slowdown at some point in the year ahead.
- 3 We're scaling back on megacap stocks after a mega run-up.

2022 Recap

- We continue to believe when 2022 is over, equity investors will think, "That didn't turn out nearly as bad as it felt at times."

The State of Future Earnings

- The consensus view is that early in 2023, earnings will collapse, bringing the stock market down with them.
- Sectoral leadership in the market suggests otherwise. Financials, industrials and materials have all outperformed in October and November. As noted by market consultant John Raphael: "It's puzzling to me why these brokers and investment banks are acting so well. Would you buy these stocks if the SPX had 10% downside?"¹
- If the economy were going to collapse in the first quarter of 2023, these economically cyclical groups would not be leading today.
- The S&P 500 equal-weighted is down -11% while the S&P 500 cap-weighted is down -17%.² Broader breadth is a bullish signal.
- My conclusions? The economy is proving too resilient, causing the "looming collapse" in earnings to remain elusive for yet another quarter. I expect earnings to drip down slowly, frustrating market bears.
- With continuing improvements on the inflation front mixed in, you have the ingredients for a strong first quarter.

What We Can Learn from Yield Curves

- Yield curves are inverted (when interest rates on long-term bonds fall lower than those of short-term bonds), a fact that requires attention and respect.
- Yield curves are not very good at predicting *when* a slowdown occurs, only that it *will* occur at some point in the future.
- Could the scenario of a weaker second half following a surprisingly strong first half occur in 2023? Said another way, could the narrative change to "weakness in the market—but from higher levels?" Maybe, but that is not the consensus.

What About Those Mega Tech Stocks?

- At their peak in 2000, the five largest tech-related stocks comprised just over 20% of the S&P 500.
- Those same stocks bottomed five years later, dropping to only 5% of the S&P 500.³
- At their peak in 2022, the five largest tech stocks comprised roughly 25% of the index.⁴ Are they now headed to 5%?
- On one hand, the 30 times average valuations of the five largest tech stocks today will never reach the triple-digit valuations of 2000.
- But what has historically stunted the growth of the mega S&P 500 stocks is the U.S. government's desire to abate their dominance—and we are now seeing that with increased regulatory scrutiny.
- Bolt-on acquisitions have boosted megasized companies' sales growth, averaging roughly 100%/year during the 2010s. Year-to-date, however, only 22 acquisitions have been completed.⁵
- We believe slowing growth rates combined with premium valuations will allow the S&P equal-weighted to continue to outperform the S&P 500 cap-weighted.
- We are reducing our exposure to these megacap stocks for these reasons.

Overseas Considerations

- Non-U.S. markets finally began outperforming the U.S. when the dollar peaked in late September.⁶
- Asia ex Japan has lead since the end of October, outperforming Europe and Japan, which have both outperformed the U.S.⁷
- As China's zero-COVID policies begin to moderate. Combined with a weaker dollar, that could make China an intriguing equity area for 2023.

“The economy is proving too resilient, causing the ‘looming collapse’ in earnings to remain elusive for yet another quarter.”

¹ John Raphael, November 20, 2022.

² Bloomberg, November 29, 2022.

³ Microsoft, Cisco Systems, Nokia, Intel and IBM. S&P 500 weighting. Bloomberg.

⁴ Apple, Microsoft, Google, Amazon and Tesla. Bloomberg.

⁵ US Weekly Kickstart, Goldman Sachs, November 11, 2022.

⁶ Bloomberg.

⁷ FactSet.

Past performance is no guarantee of future results. The returns referred to in the commentary are those of representative indexes and are not meant to depict the performance of a specific investment. See Disclosure section for index definitions.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Stocks of small- and medium-capitalization companies entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Nondiversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

INCOME



Jim Caron
Senior Advisor,
Fixed Income Team

Expect a Year of “Long and Variable Lags”

KEY POINTS

- 1 The impact of 2022 rate hikes will greatly influence asset valuations in the new year.
- 2 Below trend-line growth and significant job losses could result from the fight against inflation.
- 3 Expect short-term pain to pave the way for long-term gains for the economy.

Fed Policy Will Continue to Drive Asset Prices in 2023

- Monetary policy will continue to be the key driver of asset prices in 2023.
- Fed policy has the potential to cut back earnings, increase default risks, widen credit spreads and increase the chances for a recession. Why? Well, as stated by the Fed, rate hikes work, and there are often “long and variable lags” between a monetary policy action and its impact on the economy.
- The Fed’s mission is to help lower inflation to its 2% to 2.5% target and keep it there, durably. Will it work in 2023? If not, what’s at stake?

Inflation Remains Stubbornly High

- The pandemic caused supply shortages and excess demand driven by fiscal stimulus. In turn, the Fed tightened monetary policy to address skyrocketing inflation.
- The Fed initially believed supply shortage inflation would melt away as the pandemic ended and supply chains reopened. Goods inflation did fall sharply late in 2022, but service sector inflation remained stubbornly high and became more difficult to tame.
- The culprit? A tight labor market kept wage inflation elevated. The Fed turned its attention to weakening the labor market—enough but not by too much.

Fed’s Delicate Balancing Act

- The Fed’s dual mandate has been full employment and stable prices. It does not want to sacrifice jobs to tame inflation but, instead, delicately balance the two. It has indicated a plan to increase policy rates to around 5% and hold them there for an extended period, even if the economy slips into a mild recession.
- We expect any recession to be mild because the jobs market will likely remain strong. Quite simply, it’s difficult to expect a deep recession with such a robust labor market.
- Risks remain. Holding policy rates high while the economy is slowing can result in lower earnings, falling margins and rising default risks, all of which can have adverse effects on equity and credit valuations.

Cost-Benefit Analysis of Policy Actions

- Cost is measured by job losses. Benefit is measured in terms of quality future growth with lower inflation.
- The Fed believes that in 2023 it may have a window to tame inflation by keeping policy rates higher for longer. Economic growth and asset valuations may be collateral damage—but worth it. In the Fed's view, aggressive action now may mean eliminating the need to act more aggressively later, creating greater damage.
- With peak inflation likely behind us, high-quality bonds may benefit, while riskier assets and lower-quality credit may suffer. However, if the Fed's plan to durably stem inflation works, asset valuations may benefit over the longer term.
- Be nimble and prepared to adjust investment positions as events unfold in 2023.

“It is difficult to expect a deep recession with such a robust labor market.”

In January 2023, Jim Caron will take on a new role as Co-Chief Investment Officer, Co-Deputy Head and Senior Portfolio Manager of Global Balanced Risk Control (GBaR).

Risk Considerations: Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest-rate changes.

GLOBAL INCOME



Eric Stein, CFA
Chief Investment
Officer, Fixed Income

Fed “Pivot Trade” Likely to Drive 2023 Fixed Income Markets

KEY POINTS

- 1 The Fed’s pivot to a less aggressive monetary policy is likely to set the tone for the markets in 2023.
- 2 High-quality spread products like agency MBS and securitized debt, U.S. duration and emerging markets debt are positioned to do well.
- 3 We believe that inflation will continue to come down, in combination with a significant slowdown of the U.S. economy.

- The 2022 fixed income markets were characterized by across-the-board selloffs, sparked by both duration exposure, as inflation surprised to the upside and the U.S. Federal Reserve began raising rates, and credit spread widening, as investors anticipated a slowing economy.
- As November ended, the yield curve continued to invert, with the front end selling off and the back end rallying. But moving into December, we saw the beginning of a shift—we have started to see some spreads come in somewhat as the credit markets start to price in a Fed “pivot.”
- While the Fed pivot clearly hasn’t happened yet, the market is a forward-looking mechanism, and investors now expect rate increases to come at a slower pace than most of the second half of 2022. Even though the Fed “pivot trade” is starting to get priced in, we still think that the pivot will be the major factor in considering fixed income opportunities in 2023. Here are three areas that we believe are the most attractive:
 - **High-quality spread products.** Particularly in agency mortgage-backed securities (MBS) and some securitized products, spreads have stayed wide and have not come in as much high yield and investment grade issues. We expect an environment in which investors still want a little extra yield than U.S. Treasury securities, which would make MBS and securitized products attractive and draw asset flows.
 - **U.S. duration.** Duration is starting to look attractive, particularly as the curve inverts. While we would not overlook opportunities in the front end, we think there is value in U.S. Treasuries when the 10-year is in the range of 3.60% to 3.80%, even though that is down from the recent peak of 4.20%. To play that, investors can buy U.S. Treasury issues directly, or consider duration-heavy strategies like core plus or municipal bonds.
 - **Emerging markets (EM) debt.** We see EM debt as an attractive place for investors comfortable with a riskier asset class, particularly issues denominated in local currency. While the U.S. dollar has started to weaken, it is still at very strong historical levels. If it continues to weaken in 2023, that would certainly be good for EM debt priced in non-dollar local currencies. Additionally, EM corporate debt—credit sectors—typically do well in a weak-dollar environment.

- It's worth stressing that the most important variable looking forward is what inflation will be over the medium term. We believe that inflation will continue to come down consistent with a slowdown in demand as the U.S. economy weakens, and improvements in various supply side constraints. However, if inflation surprises on the upside and prompts the Fed to be more aggressive, fixed income broadly will have another poor year.
- Our view is that the Fed will moderate its increases. Policymakers have begun to note that monetary policy operates with "long and variable lags." We view this as dovish messaging that the Fed is closer to its pivot. It also implies that the Fed has done far more in 2022 than anyone would have expected at the end of 2021. In sum, fixed income markets are like to be driven in 2023 by a less aggressive Fed and a slowing economy.

"The Fed did far more in 2022 than anyone would have expected at the end of 2021."

Risk Considerations: An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer's obligation in the event of non-payment, or that collateral can be readily liquidated. The ability to realize the benefits of any collateral may be delayed or limited. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher-rated investments. As interest rates rise, the value of certain income investments is likely to decline. Bank loans are subject to pre-payment risk. ESG - There is no assurance strategies that incorporate ESG factors will result in more favorable investment performance.

EMERGING MARKETS



Jitania Kandhari
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Equity

Opportunities in Emerging Markets, Navigating Beyond China

KEY POINTS

- 1 Emerging markets (EM) have better growth, lower inflation, and less sovereign and private debt, yet EM equities and currencies trade at crisis-level valuations.
- 2 Despite the slowdown in China, we expect many other EM countries to see an acceleration in growth, which will drive earnings and market share.
- 3 The growth story is underpinned by the post pandemic recovery, a manufacturing renaissance, commodity tailwinds, digitization and a favorable political cycle.
- 4 We believe that most investors are under-allocated to EM, considering the potential returns from this asset class.

During the 2010s EM equities suffered their worst performance as an asset class going as far back as the 1930s. Fast forward 10 years and most emerging countries, with the exception of China, started the 2020s in much better shape economically than in the previous decade. Emerging Countries such as Brazil, Mexico, India, Indonesia and the GCC (Gulf Cooperation Council) outperformed not only the MSCI Emerging Markets Index but even the S&P 500 Index in 2022.

Several factors have contributed to this outperformance. The headwinds of the past are becoming tailwinds that we believe should provide support for many years to come.

- Relative growth differentials favor EM equities.
- EM sovereigns are healthier compared to developed markets (DM) governments due to better public debt and fiscal situations.
- EM corporates are in better shape compared to DM corporates due to deleveraging.
- EM external balances have improved relative to DM.
- EM equities and currencies are trading at decade-low valuations.

Navigating beyond China

Growth in China will be weighed down due to its high debt, slowing working-age population growth and declining contribution from trade. In the 2000s, China became the manufacturer to the world, and in the 2010s, China's economy grew thanks to consumer Internet service giants.

We believe the next turn in this decade will be toward green technology and science-based industries like semiconductors, artificial intelligence and high-end manufacturing. Despite the slowdown in China, we expect many other EM countries to see an acceleration in growth, which will drive relative earnings and market share.

The growth story of EM is underpinned by several factors:

- Post-COVID recovery led by credit creation after a period of deleveraging
- Manufacturing revivals in certain markets led by the “China plus one” strategy that drives reshoring and friend shoring
- Commodity boom driven by resource-intensive decarbonization, which benefits resource-rich economies
- Boosts to productivity and growth led by digitalization across most EM regions
- Favorable political cycles in several pockets of EM

It is important to note that since the MSCI index inception in 1988, emerging economies have weathered many storms—and yet they have outperformed developed markets, perhaps surprising many commentators. Since 1988, the MSCI EM Index has gained 9.7% annualized, outperforming many of the MSCI tracked asset classes, albeit with higher volatility.

This is why we believe EM offers greater opportunity for active management to add value over the course of EM economic and market cycles. While drawdowns in EM are common, these often provide the best entry points for gaining exposure to the long-term positive trend return. Despite better growth, less debt and lower inflation, EM equities are trading at crisis-level valuations today.

We believe that most investors are under-allocated to EM, considering the potential returns from this asset class. For many investors, EM remains unloved and clearly under-owned. The environment for investing in EM will never be easy, but by focusing on active country selection, stock selection and structural themes, we believe investors can reap the rewards of investing in these markets particularly at this stage of their economic and market cycle.

“Most emerging countries, with the exception of China, started the 2020s in much better shape economically than in the previous decade.”

Risk Considerations: The value of equities securities fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. When comparing asset classes, keep in mind that each has differences and that all investments involve risks, including the possible loss of principal. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets.

MULTI-ASSET



Andrew Harmstone
Head of Global
Balanced Risk Control
(GBaR) Senior
Portfolio Manager,
Global Multi-Asset

Rebalancing Acts

KEY POINTS

- 1 The global economy should normalize as pandemic pressures ease.
- 2 Imbalances in labor and energy markets pose a greater inflation risk for Europe than the U.S.
- 3 China is redoubling efforts at structural reform to put its economy on a path of long-term stability.

Labor Pains

- With pandemic-related pressures beginning to wane, global rebalancing may be a principal market driver in 2023. We foresee three key areas of rebalancing: labor markets, the energy crisis and China's structural reform shift.
- In developed markets, post-COVID employment conditions have favored workers over employers. Even as growth is slowing, the labor market remains resilient. In the U.S., for example, job openings still sit at high levels, but the number of new positions has come down by 1.15 million from a peak of 5.1 million in March 2022. U.S. wage growth is also normalizing, with the rate running at roughly one-half of its 6.6% high in January 2022.¹
- Labor market rebalancing is likely to be slower in Europe, and risks of a wage-price spiral are higher. Compared to prepandemic levels, indicators such as total employment numbers, hours worked and participation rates have risen more in the eurozone than in the U.S. Labor shortages in the industrial sector should sustain tight employment markets, raising risks that wage increases continue to exert upward price pressures.

Evolving Energy Landscape

- We expect a transitional year for energy markets. Higher oil and gas prices should combine with slowing economic activity to dampen demand. However, sanctions on Russia are likely to result in tight gas supplies globally. As Russian gas exports look set to fall more sharply next year, we expect that some buyers may switch their energy mix with a move to oil from gas.
- OPEC's recent decision to cut production quotas underscores the role that high prices play to incentivize investment. A fall in prices now could disincentivize investment and spell higher prices when demand recovers. In 2023, we expect prices to be supported in the \$90 to \$100 per barrel (p/b) range. If China achieves a successful reopening from its zero-COVID policy, normalization of demand could push prices above \$100 p/b.

Change in China

- Global supply chain realignments, demographic change, debt deleveraging and a structural shift toward a consumption-led economy will be key trends for China in 2023. Manufacturing and trade are becoming less important in driving economic activity partly because of reduced offshoring by Western companies and rising wage costs in China.
- The debt-fueled investment boom has weak foundations, with the country's corporate debt-to-GDP ratio at 218% in 2021,² and the property market now saturated. The Chinese government is aware of the urgency for change, which will entail reducing inequality and expanding access to the middle class through its "common prosperity" agenda. These transitions will need to be managed in tandem with the near-term challenge of navigating a COVID reopening.

Investment Implications

- Economic rebalancing may be tricky in 2023, following a period of profound disruption. Policymakers must carefully weigh their options as they attempt to suppress inflation without harming the economy and financial markets. Labor market and energy challenges will not facilitate a smooth walk across the tightrope for Europe, but the region does appear to be more surefooted than China. The U.S. economy, more flexible and energy independent, has a slight advantage in unwinding its imbalances.
- Overall, we expect fixed income assets to outperform equities in the first half of 2023. Ultimately, the range of potential macro scenarios is wide and dependent on how central banks proceed, particularly the U.S. Federal Reserve. We expect to see a shallow recession and moderate, but still largely restrictive monetary policy. In our view, the paths to rebalancing, and not simply the macro outcomes alone, will matter for markets in 2023. Staying nimble and adjusting investment positions as events unfold will remain key.

“Staying nimble and adjusting investment positions as events unfold will remain key.”

¹ U.S. Bureau of Labor Statistics, Morgan Stanley Investment Management, November 30, 2022.

² Bloomberg Economics, December 31, 2021.

Risk Considerations: There is no assurance that the strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the adviser's asset allocation methodology and assumptions regarding the underlying portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in commodity-linked notes involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall. Equity and foreign securities are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Diversification does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

CALVERT



John Streur
Chief Executive
Officer, Calvert
Research and
Management

New Framework for ESG Disclosure and Responsible Investing Underway

KEY POINTS

- 1 Major events in 2022 have caused a shakeout in the responsible investment industry that will bring meaningful change into 2023 and beyond.
- 2 Globally, the industry is moving toward more intensive ESG research that establishes clear connections between corporate behavior and financial outcomes.
- 3 Government ESG disclosure standards established in 2022 will help create a more transparent, consistent framework for security selection and corporate engagement.

The ESG and Responsible Investing markets have grown rapidly over the past decade because investors recognize that the world faces substantial environmental and social challenges, and that companies successfully addressing these challenges stand to benefit. Major events of 2022 have caused a shakeout in the industry and imply meaningful change today and into 2023.

To stay relevant as capital market participants in 2023 and beyond, we believe responsible investors must intensify research into how well companies are managing their specific exposures to financially material environmental and social factors, analyzing their near- and long-term financial impacts. Multidimensional research with clear connections between corporate behavior and corporate financial outcomes must inform both security selection and corporate engagement efforts, including ESG activism.

Greater Disclosure Required of ESG Asset Managers

For years, responsible investors have propelled companies to increase transparency and disclosure of their ESG performance across factors ranging from carbon emissions to workplace diversity. Now it is critical that responsible investment asset managers provide transparency into their own research methodology. Investors need clarity around the linkages between corporate ESG performance, financial outcomes, security selection and the results of corporate engagement and activism.

Understanding corporate governance will continue to be relevant for all types of investors, but the need for depth and granularity in responsible investment research and corporate engagement will dominate the ESG and responsible investing business in 2023 and beyond.

The responsible investing teams and firms that can succeed in doing this will continue to thrive and gain investor market share, becoming increasingly relevant participants in global capital markets.

New Responsible Investing Framework

We believe the events of 2022 will prove to have been seminal for responsible investing and ESG research, helping shape the framework for a rapidly changing investment landscape. The combination of powerful geopolitical events, along with ambitious government regulations aimed directly at responsible investing, are together creating a new reality for market participants.

The sum of geopolitics largely shows that individual entities—people, companies, countries—predominantly act in their own self-interests, as opposed to the long-term needs of global society. This makes solving issues that impact the global commons, such as climate change or

COVID, very difficult for society to solve. Multiple situations today serve as proof points: the war in Ukraine, numerous conflicts between China and the West, divergent outcomes between rich and poor countries in the response to COVID, and inadequate progress among the world's large and rich countries to effectively deal with climate change.

Understanding this reality is critical to grasping the need for voluntary, market-led solutions to these massive challenges, and the need for stronger, deeper ESG research and engagement. We need corporations that can advance viable solutions do so while producing competitive financial returns for investors. Finding those winners and differentiating the rest requires exhaustive ESG research.

Government actions in 2022—in terms of setting standards for ESG and responsible investing, as well as intervention in trade and industrial policy—underscore how a shift to deeper research and voluntary, market-led solutions are under way and will likely dominate in 2023. The United States Department of Labor new ESG rule, “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,” makes clear the need for in-depth ESG research focused on financially material factors. This rule will set the entry-level standard for responsible investing going forward. In the EU, the Sustainable Finance Disclosure Regulation (SFDR) rules make clear the need for investment firms to define their approach to responsible investing. These rules, combined with ongoing enforcement actions in the UK, EU and U.S., make crystal clear that responsible investment firms and products must provide realistic expectations and real transparency into research and investment processes.

Stronger Capital Markets

The impact of deeper ESG investment research, clarity on ESG linkages to financial outcomes, and greater transparency into responsible investment processes has already created a narrower and more competitive field. Firms are adjusting their marketing claims and investors are conducting intensified due diligence. At the same time, corporations that are the subject of this research are adjusting their public-facing statements and strengthening the financial discipline of their sustainability-related capital investments.

We believe the outcome will be to strengthen capital deployment, create measurable differentials between corporations that can manage well and those that cannot, and enhance how capital markets function. Greater transparency, greater disclosure, greater focus on financial outcomes—these are the required underpinnings of successful, market-led solutions, consistent with the realities of the world we experienced in 2022. We have seen how individual entities behave in promoting their own self-interest, with minimal ability of governments to exert control, despite their efforts. Strong capital market function can counter this, advancing the needs of society while providing competitive returns to investors.

“The need for depth and granularity in responsible investment research and corporate engagement will dominate the ESG and responsible investing business in 2023 and beyond.”

In January 2023, John Streur will take on the role of Chairman, Calvert Research and Management, focusing on investment innovation, client engagement and thought leadership.

Risk Considerations: There is no assurance strategies that incorporate ESG factors will result in more favorable investment performance. ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

COUNTERPOINT GLOBAL



Manas Gautam
Head of Global
Endurance

This Too Shall Pass

KEY POINTS

- 1 While macro factors may be driving performance over the short-term, we continue to be focused on the fundamentals of our portfolio companies and their long-term compounding potential.
- 2 In our view, equities will likely outperform over the long term because they provide ownership in the creativity, ingenuity and productivity of hundreds of thousands of talented workers.
- 3 We believe a higher cost of capital will lead to fewer market entrants and less competition, which should benefit companies that have already established valuable businesses and brands.

As a team, we have never maintained a market outlook and believe that basing investment decisions on macro forecasts can be a futile exercise. However, we do consider how micro and macroeconomics can impact the fundamentals and cost structures of our businesses.

What We Are Seeing

- Rising interest rates, inflation and geopolitical tensions have led to uncertainty and character-testing volatility, impacting business sentiment and driving down share prices around the world.¹
- Guidance-obsessed market participants have become increasingly fixated on short-term forecasts, losing sight of the underlying fundamentals and long-term growth potential for companies.
- As the Federal Reserve increases interest rates to tame inflation, we have seen the dollar strengthen year-to-date, impacting earnings power for companies that export products and services and have non-dollar-denominated sales.
- While these non-fundamental factors may be driving performance over the short-term, we continue to believe these headwinds are unlikely to materially impact the long-term cash generation and intrinsic value of the types of businesses we own.

What We Are Doing

- We maintain our belief that equities will likely be the best-performing asset class over the long term as they provide ownership in the creativity, ingenuity and productivity of hundreds of thousands of talented workers. While money can be inflated, talent cannot.
- We do not spend a lot of time worrying about the ups and downs of the market or the forecasts of economists and pundits. Instead, we focus on the compounding potential and fundamentals of our portfolio companies.
- We continue to reassess the competitive advantages and qualitative characteristics of the businesses we own. Strength of customer value proposition, growth profile and earning power; track record of management team, direction and size of their moat; and short- and long-term capital needs remain primary concerns when evaluating companies.

- We are finding attractive opportunities within intellectual property-based and automation and productivity-enabling businesses, which we believe can produce large-dollar volume increases with minor additional capital investment.
- We continue to avoid commodity-related sectors given the capital-intensive nature of these businesses, unpredictable prices and underappreciated liabilities.
- While a stronger dollar and higher energy prices have created a major headwind for companies in Europe, it has also created pockets of opportunity, as we believe the share prices of some very attractive businesses have been penalized solely as the result of their location.

What We Are Watching

- While it is too early to tell if inflation has peaked in the U.S., we are observing a lowering of input costs that should help improve our companies' margins.
- We continue to assess the longer-term implications of a higher cost of capital and its overall impact on the competitive landscape. With the days of easy money behind us (for now), we expect fewer market entrants and less competition, which should benefit companies that have already established valuable businesses and brands.
- Stock-based compensation plans have been a low-cost funding mechanism for emerging and innovative businesses. Given the recent drawdown, we are monitoring whether companies will increase the use of cash compensation and any subsequent impact on profitability and dilution.
- Our portfolio companies appear to be increasingly focused on their cost structures and doing more with less, which should improve their free-cash-flow profitability. Will Price's Law—that 50% of contributions are done by the square root of the total number of contributors—hold true?

“We maintain our belief that equities will likely be the best-performing asset class over the long term, as they provide ownership in the creativity, ingenuity and productivity of hundreds of thousands of talented workers. While money can be inflated, talent cannot.”

¹ It is important to note, however, that we are bottom-up, fundamentals-driven investors and do not believe that share price volatility necessarily equates to risk.

Risk Considerations: There is no assurance that a strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. In general, equity securities' values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Investments in small- and medium- capitalization companies tend to be more volatile and less liquid than those of larger, more established, companies. Derivative instruments may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. Privately placed and restricted securities may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk).

INTERNATIONAL EQUITY



William Lock
Head of International
Equity



Bruno Paulson
Portfolio Manager,
International Equity

High-Quality Compounders Offer Recurring Revenues and Pricing Power

KEY POINTS

- 1 Companies with pricing power and recurring revenues that can grow their earnings steadily in real terms across cycles are likely to outearn the market.
- 2 The sharp compression in the valuation of higher-growth stocks has provided the opportunity to add some new names to the portfolio.
- 3 High-quality compounders with recurring revenues and pricing power should protect revenues and margins in a downturn.

What We Are Seeing

- The MSCI World Index forward P/E multiple is more in line with the average from 2003 to 2019 (before COVID), shifting our focus to the vulnerability of broader market earnings.
- Recent client meetings suggest that many asset owners have been reducing exposure to higher-growth stocks and are drawn to the more defensive characteristics of high-quality stocks.
- We believe now is a particularly good time to own compounders, since their pricing power (the ability to pass on costs to consumers) and recurring revenues (the propensity toward repeat purchases) can make their earnings resilient in tough times.
- High-quality compounder companies that can grow their earnings steadily in real terms, across cycles, are likely to outearn the market, just as they have done over the last few decades. When supply normalizes (or possibly even overbalances into excess supply), true pricing power comes into its own.
- Investing in companies with true pricing power is crucial because earnings should be relatively resilient in a squeeze on the wider market's profitability.

What We Are Doing

- We continue to focus on high-quality compounders regardless of the market backdrop.
- Among these are favorite consumer brands, mission-critical software services and quality-assured health care companies that possess strong intangible assets, which are generally difficult to recreate or duplicate by competitors.
- The sharp compression in the valuation of higher-growth stocks has provided the opportunity to add some new names to the portfolio and has influenced the additions and reductions within our global portfolios this past year.

What We Are Watching

- There are two ways of losing money in equity investing: either the earnings go away or the multiple goes away. The main risk we see ahead is earnings. However, with forward earnings expected to rise over the next year and margins close to record levels, we do not see earnings signaling a significant economic slowdown, let alone a serious recession. Meanwhile, current derating of some stock P/E ratios has reduced, but not completely removed, the multiple risk.
- We believe the major threat to earnings in the short term is the prospect of an economic slowdown as central banks continue to attempt to counter inflation through higher rates. The pace may differ by region. Longer term, there could be further pressures on earnings, such as the need to build more resilient supply chains or potentially higher corporate tax rates as governments look to repair their finances.
- Given the uncertain macroeconomic landscape and the room for policy errors, we continue to advocate for a portfolio of high-quality compounders. The combination of these companies' recurring revenues and pricing power should protect revenues and margins in a downturn, providing asset owners with earnings resilience and relative predictability through tougher, more volatile times.

“Investing in companies with true pricing power is crucial because earnings should be relatively resilient in a squeeze on the wider market’s profitability.”

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EMERGING MARKETS EQUITY



Vishal Gupta
Portfolio Manager,
Emerging Markets
Leaders

After a Tough Decade, Emerging Markets Are Ready to Shine

KEY POINTS

- 1 It's time for emerging markets to shine in the next decade.
- 2 Growth expectations have been reset and appear to be priced in.
- 3 Opportunities await, even with risks ahead

What We Are Seeing

- 2022 capped a difficult decade-plus period of underperformance for emerging markets (EM).
- Many wonder, for example, whether some markets like China is investable at all, after a series of regulatory overhangs, political developments and strict COVID policies.
- Last year saw a reset of growth expectations, irrespective of the earnings growth potential and managements' execution ability, while U.S. dollar strength seems to have peaked.
- EM economies should benefit from not having to counteract the short-term "sugar high" of COVID stimulus, as is the case in many developed market countries.
- Despite global worries over the war in Ukraine, China-U.S. tensions and an impending recession in the U.S., EM seems to be well-positioned for a constructive 2023—and beyond.

What We Are Doing

- While EM Leaders is primarily focused on bottom-up, structural opportunities, we are also adapting to higher global interest rates which are unlikely to drop significantly in the years ahead.
- EM Leaders was slow to respond to the sharp jump in rates and the massive derating of companies that are not yet profitable. We have addressed this by shifting the portfolio in recent quarters.
- Since the derating of strong compounders (defined as companies with high quality, franchise businesses, recurring revenues and pricing power, among other things), we have deployed capital into industry leaders with clear earnings visibility, while finding new investment themes such as the rise of domestic manufacturing and brands.
- While the market focuses on the near-term path of inflation rates, we are spending more time on the road with the company management teams of existing holdings, always on the lookout for new ideas.

What We Are Watching

- We have an eye on China, which has been negatively impacted by COVID-19 lockdowns. Political developments could heighten policy risk, but given economic pressures and government support measures, we expect economic activities will eventually normalize—and provide surprises on the upside.
- The market has yet to differentiate between winners and losers, but we believe that will be evident in the next cycle. For example, Indian IT services with a much lower growth outlook are trading at the same multiples as niche, digital IT services companies with twice the likely growth rate.
- The seasoned management teams of our portfolio companies are reassessing and recalibrating their growth strategies to drive profitability and increase their market share.
- Geopolitical tensions between the U.S. and China will likely provide entry points for other EM supply-chain capabilities, like iPhone production shifting to India.
- For the first time in a decade, we are seeing high-quality EM growth companies offering 15 to 20 times PEs, coupled with 20% return on invested capital (ROIC) and 20% earnings growth—a great investment backdrop for the next three to five years.
- We feel that some of the larger continental-sized markets within EM are well-positioned for the coming decade.

“We expect emerging markets to benefit from the shift in growth for the decade ahead, with entry prices looking attractive.”

GLOBAL LISTED REAL ASSETS



Laurel Durkay
Head of Global Listed
Real Assets

ESG, Lending Recovery and Data Growth Have the Potential to Fuel REITs

KEY POINTS

- 1 A recovery in credit and lending markets has the potential to fuel M&A.
- 2 Environmental, social and governance (ESG) and sustainability will significantly influence the future risk and total return prospects of REITs.
- 3 Early adopters of property technology (proptech) are well positioned to mitigate future expenses.

What We Are Seeing

- As real estate prices rise, property values tend to appreciate, while cash flow streams also generally benefit. Besides top line benefits, REITs typically have high margins and operating efficiency, so that their business models tend to be less impacted by the upward pressure on expenses that comes from inflation.
- The stabilizing interest rate environment expected in 2023 should bolster real estate investing. While U.S. REITs have historically underperformed U.S. equities during periods of large interest rate increases, they have outperformed three, six and 12 months after a significant rise in interest rates.¹
- Office utilization rates have settled in at between 40% to 80% of pre-COVID levels, depending on the city and region.
- Landlords who have already invested in energy efficiency, best-in-class air filtration and water and waste reductions will be the best positioned. Obsolescence risk will increase substantially for “carbon stranded” buildings unable to achieve the greenhouse gas emissions reductions necessary to be aligned with a 1.5°C pathway.

What We are Doing

- We focus on quality as measured not only by the attractiveness of a REIT’s assets, but also by the attractiveness of a REIT’s cash flows. We look for companies with defensive and growing earnings that trade at attractive relative multiples, and may offer attractive dividend yields.
- We have an underweight position to offices and continue to scale back. Work-from-home policies will likely continue to hinder office demand, and uncertainty over future office absorption is expected to linger. Meanwhile, labor markets are moderating, with increased layoffs and hiring freezes.

- Secular headwinds remain for retail amid expectations for growth in e-commerce and the focus on omnichannel distribution. We're taking advantage of the renewed importance of physical stores benefiting from increased brand recognition and stronger insulation from supply chain woes. We favor non-discretionary and convenience-oriented retail landlords, such as owners and operators of open-air shopping centers.
- Sustainability is a core element of our research process, comparable to our focus on other factors such as building quality, tenancy, occupancy, and strategic business plans.

What We are Watching

- We anticipate a recovery in credit and lending markets. With roughly \$400 billion of undeployed capital on the sidelines,² we expect to see an increase in M&A activity, thereby crystalizing value and potentially favorable returns for REIT investors.
- Companies without a sufficient annual capital expenditure (CAPEX) plan devoted to sustainability projects will struggle. Real estate is heavily impacted by the shared goal of businesses, governments and investors to achieve carbon neutrality by 2050.
- Data growth and the need for digitized infrastructure underlying real estate will continue to be very positive. Early adopters of property technology (proptech) will be better equipped to mitigate expense pressures.
- Contracted rental streams with inflation-linked escalations and the necessity-based nature of real estate, coupled with limited new supply additions due to rising construction costs, may portend limited downside in real estate cash flows.

“We expect to see an increase in M&A activity, thereby crystalizing value and potentially favorable returns for REIT investors.”

¹ Sources: Bloomberg, MSIM. Rising-yield periods are the 10 largest 1-month increases in the yield of the U.S. 10-Year Treasury since 2000 and through September 30, 2022. These rising-yield periods are 4/5/00-5/8/00; 11/7/01-12/7/01; 6/25/03-7/29/03; 3/23/04-4/23/04; 12/30/08-1/30/09; 4/27/09-5/27/09; 11/10/10-12/14/10; 6/5/13-7/5/13; 3/7/22-4/7/22; and 8/26/22-9/27/22. Average is calculated as the simple average of relative returns of REITs and equities over the time periods shown. U.S. REITS: FTSE Nareit All Equity REITs Index; U.S. Equities: S&P 500 Index. Returns shown during subsequent periods are calculated as an average cumulative return from the ending dates of the 12 rising-yield periods shown above, over the subsequent 3, 6 and 12 months.

² Source: Preqin.

Past performance should not be construed as a guarantee of future performance. Returns provided in USD terms. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend might begin. It is not possible to invest in an index. Provided for illustrative purposes only.

Risk Considerations: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility. Changes in real estate values or economic downturns can have a significant negative effect on issuers in the real estate industry including REITs. Diversification does not eliminate the risk of loss. Active management attempts to outperform a passive benchmark through proactive security selection and assumes considerable risk should managers incorrectly anticipate changing conditions.

FLOATING-RATE LOANS



Andrew Sveen, CFA
Head of Floating-Rate Loans, Portfolio Manager

The Paradox of Opportunity

KEY POINTS

- 1 Loans have outperformed every major equity and bond index, and offer a yield to maturity of about 9.4%, as of mid-November 2022.
- 2 Thorough credit research, as practiced by MSIM's floating-rate loan team, is especially important in this environment.
- 3 In 2023, loans offer the opportunity for high income, capital appreciation and participation in the rising rates that may lie ahead.

What We Are Seeing

- Floating-rate loans present a bit of a paradox at the end of 2022. Through mid-November, the asset class outperformed every major equity and bond index by a wide margin. Yet there are good reasons to consider the asset class a cheap buying opportunity in 2023.
- The core floating-rate feature of loans was highly attractive in a year when the U.S. Federal Reserve raised rates by 300 basis points. Loans escaped the downside peril of duration, while loan fund distributions nearly doubled from the beginning of 2022.
- Investors flocked to loans trading at \$98 and yielding 4.5%, based on the Morningstar LSTA Leveraged Loan Index. But now, with loans trading at about \$93 and a yield to maturity around 9.4%, buyers are harder to find. Call it the paradox of opportunity.

What We Are Doing

- We have always maintained that loans are an asset class exposure that benefits from the thorough due diligence of credit research and active management, especially in this environment.
- Our investment team of 40-strong has re-underwritten our portfolio companies, gauging how they may be affected by today's set of risks, like higher input and debt service costs.
- As part of this effort, we have resized or in some cases exited positions, where appropriate. Despite the spike in inflation and rising rates over the year, our "watch list" of credits—where we are truly concerned in the near term—remains limited.

What We Are Watching

- For investors, the important question is whether the prices and yields on loans are compensating for the heightened recession risks in today's market.
- We believe the answer is a solid "yes." In mid-November, loans had an approximate seven-point discount from par. Conservatively assuming that 70% of defaults will be recovered (historically, that number has been 75%), the discount in the market today implies a cumulative 23% default rate ahead.

- For context, that figure is almost double the great financial crisis of 2008, and about five times the deep (albeit short) COVID recession. By contrast, the current default rate is below 1%. Though we expect annual levels to rise somewhat, it's clear to us that the market is oversold.
- Historically, starting yield has been a good guide to total return. With a floating-rate loan yield starting at 9.4% in November 2022, we believe returns that include capital appreciation in excess of coupon income may well be in store.

We'll never "call a bottom," and prices may be unpredictable in the near term. That said, we think loans trading at a deep discount elevates the opportunity for investors. It's a chance for high income, capital appreciation and participation in the rising rates that may lie ahead.

"With a floating-rate loan yield starting at 9.4% in November 2022, we believe a 'coupon-plus' total return in 2023 may well be in store."

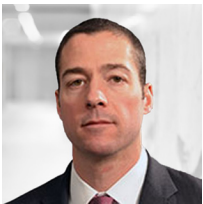
The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

Risk Considerations: Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short-term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

HIGH YIELD



Stephen C. Concannon, CFA
Co-Head of High Yield, Portfolio Manager



Will Reardon
Institutional Portfolio Manager, High Yield

The Lure of Long-Term Value

KEY POINTS

- 1 Corporate fundamentals of high-yield issuers are, on average, closing out 2022 from a place of strength, but may face strong headwinds in 2023.
- 2 We favor defensive sectors and higher-quality credits, particularly where long-term value is present.
- 3 We stand ready to add risk in a disciplined manner when spreads exceed defined thresholds.

What We Are Seeing

- In 2023, we expect to see a shift in focus toward slowing global growth. Monetary policy will remain a prominent market driver, but the prospect of recession in several developed markets will likely be a trigger for volatility throughout the year.
- In high yield, corporate fundamentals still appear to be somewhat resilient, and the market is entering 2023 from a place of relative strength. Leverage appears to be manageable, and interest coverage is hovering near all-time highs.
- However, strong fundamentals at the end of 2022 are likely to weaken in 2023. In particular, we expect corporate earnings to fall in line with slowing business activity at the same time that interest coverage softens—especially for issuers with elevated exposure to floating-rate debt.
- Primary issuance, which remained languid throughout 2022, may start to increase in 2023 as companies become more comfortable with a regime where interest rates remain higher for longer.

What We Are Watching

- Receiving adequate compensation for taking credit risk is what drives our investment decisions. Therefore, we are re-underwriting our investments to ensure appropriate payment for the underlying risks, while also seeking out attractive upside in an environment of rising credit risk.
- We deem current valuations to be fair, on average, but foresee further spread widening as the most likely path forward. Should spreads move materially wider, we could see an entry point emerge that offers the potential for attractive long-term risk-adjusted returns. To this end, taking a disciplined approach to incrementally adding risk when credit spreads surpass defined thresholds will be key for high yield in 2023.

What We Are Doing

- We have reduced exposure to cyclicals and segments exhibiting unattractive asymmetric risk/return characteristics. We prefer defensive sectors trading wide of historical norms. For example, the health care sector's average spread typically trades at around 40 basis points (bps) tighter than the ICE BofA U.S. High Yield Index average, but the sector traded 158 bps wider on November 30, 2022.
- We are maintaining a bias toward higher-quality credits and issuers with durable free cash flow—particularly within high-margin, service-based segments that benefit from strong recurring revenue.
- Finally, we stand ready to add risk in a disciplined manner when spreads exceed defined thresholds.

“Taking a disciplined approach to incrementally adding risk when credit spreads surpass defined thresholds will be key for high yield in 2023.”

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Risk Considerations: Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments rated below investment grade (typically referred to as “junk”) are generally subject to greater price volatility and illiquidity than higher rated investments.

AGENCY MBS



**Andrew
Szczurowski, CFA**
Head of Agency MBS,
Portfolio Manager

As Investors Shed Risk, Demand for Agency MBS Likely to Pick Up

KEY POINTS

- 1 With the specter of recession and credit defaults on the horizon, money manager demand for agency MBS is set to pick up in 2023.
- 2 Higher-coupon agency MBS yields are now close to 6% for the first time since the early 2000s.
- 3 To mitigate against the risk to our higher-coupon theme from prepayments in 2023, we are moving to specified pools that can offer pay-up convexity¹ on top of attractive spreads.

What We Are Seeing

- For the first time in over a decade, we expect investors will have to contend with a true credit default cycle in 2023. Under this scenario, bond selection will be critical.
- Fortunately, investors are once again receiving attractive yield from high-quality bonds. Fourteen years of central bank policies setting artificially low rates have ended with government-sponsored, agency MBS yields at levels not seen since before the global financial crisis.
- In our view, supply of agency MBS is set to fall significantly in 2023, as mortgage rates approaching 7% have dramatically slowed U.S. home sales and eliminated any cash-out refinance supply.
- Declining supply in 2023 should more than offset the absence of the Federal Reserve in the MBS market, providing a nice technical tailwind for MBS spreads.
- Short duration now means more yield: The Fed's ongoing battle to cool inflation has led to the most inverted Treasury curve since the early 1980s. Investors can now pick up over 70 basis points (bps) by staying at the short end of the yield curve.
- 2022 marked the worst year on record for the MBS market. On the upside, we believe this has created an attractive entry point for intermediate- or long-term investors, as high starting yields and wide spreads have historically preceded periods of strong total returns.

What We Are Doing

- After spending nearly an entire decade below 3%, higher-coupon agency MBS yields are now close to 6% for the first time since the early 2000s.
- We expect mortgage interest rates to decline in 2023 from their two-decade high, as spreads narrow from their 2022 wides.
- We continue to believe that the best value in the sector can be found in higher-coupon MBS, which offer an attractive combination of higher yields, wider spreads and shorter durations.
- To mitigate against the risk to our higher-coupon theme from prepayments in 2023, we are moving to specified pools that can offer pay-up convexity on top of attractive spreads, which we believe will offer some insulation as mortgage rates decline.

What We Are Watching

- **MBS spreads.** Spreads are wide relative to other fixed income sectors, such as investment-grade corporates. Despite increasing concerns of a recession on the horizon, lower credit quality, A-rated corporate bonds are trading nearly 30 bps tighter than higher-coupon, AAA-rated agency MBS.
- **Crossover buyers.** We will watch the pace of demand from crossover buyers in core bond funds who are looking to move up in quality—out of investment-grade corporates and into AAA agency MBS—as economic growth slows.
- **Demand for agency MBS.** As investors are now paid to help mitigate against the risk of a recession, we expect to see demand for agency MBS to pick up—especially among money managers who may seek to shed credit risk before defaults begin to escalate. Historically, these securities have produced positive total returns in periods following the onset of a recession. On average, agency MBS have outperformed investment-grade corporates by nearly 400 bps.²
- **Bond market volatility.** We expect a significant decline in volatility across the bond market as more clarity on the direction of inflation emerges, with less uncertainty around the amount of Fed tightening required.

“Short duration now means more yield: The Fed’s ongoing battle to cool inflation has led to the most inverted Treasury curve since the early 1980s.”

¹ Convexity measures the sensitivity of a bond’s duration to changes in yield.

² Source: Bloomberg. Agency MBS represented by the ICE BofA MBS Index, investment-grade corporates represented by the ICE BofA US Corporate Index; measured over six recessions since the creation of MBS in the late 1970s, from 1980 to 2020.

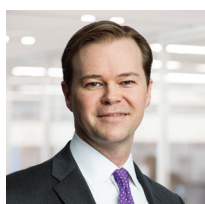
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EMERGING MARKETS DEBT



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Markets Debt,
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Bradford Godfrey,
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Signals Indicate an Enticing Entry Point for EM Debt

KEY POINTS

- 1 Along with the improving macro, fundamental and technical picture, compelling valuations point to a market reset for EM debt.
- 2 We see a number of attractive opportunities across the universe, particularly in local interest rates and also in corporate spreads.
- 3 Sentiment swings may affect EM assets in 2023, although market pessimism appears to have peaked.

What We Are Seeing

- Several signs indicate that emerging markets (EM) debt is poised for a turnaround in 2023. To start, valuations appear compelling on a historical basis and relative to other asset classes. In our view, market pricing in EM debt for macro uncertainty was aggressive through most of the past year—perhaps more than for any other asset class.
- However, macro uncertainty is now beginning to recede in two key ways: First, the U.S. Federal Reserve's hawkish policy stance appears to have topped out, as inflationary headwinds look to be gradually dissipating. Second, while the future of China's COVID policy is not clear, it appears that authorities are starting to relax restrictions amid growth concerns and increasing social pressures.
- Many EM economies are revising growth forecasts upward in line with stronger fundamentals. Monetary discipline should pay off for those countries that took early and decisive action on raising interest rates, as they will enjoy greater flexibility in managing central bank policy to stimulate growth ahead.
- The technical picture is also showing nascent signs of recovery. EM debt recently saw net inflows return after record outflows of \$87 billion from the asset class over the first 10 months of 2022.¹
- We believe that outflows have likely bottomed out and anticipate stronger net flows in 2023. In particular, we expect multi-sector managers, who drastically cut exposure to EM bonds in 2022, to continue increasing allocations as the outlook improves.

What We Are Doing

- Based on our bullish views, we have been adding select opportunities across our EM debt portfolios. We remain particularly optimistic about EM local interest rates, as real yield differentials between emerging and developed markets appear very attractive. While slightly off their peak, those differentials remain among the highest levels seen since the global financial crisis.

- Most recently, we have also been adding selectively to our positioning in EM currencies, where compensation appears comparatively attractive, given the level of risk. On the hard currency side, we maintain a slight preference for EM corporate over sovereign debt.

What We Are Watching

- We continue to evaluate all opportunities on a bottom-up, country-by-country and company-by-company basis, as we believe this to be the best way to find attractive EM turnaround stories.
- We recognize, however, that the broad asset class remains more sensitive to macro conditions and market sentiment at present. So we continue to monitor developments in key global markets, such as the U.S. and China, and their impact on the asset class.

“We remain particularly optimistic about EM local interest rates, as real yield differentials between emerging and developed markets appear very attractive.”

¹J.P. Morgan, Global Emerging Markets Research: EM Flows Weekly, November 18, 2022.

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INVESTMENT GRADE CREDIT



Richard Ford
Global Head of
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Credit, Portfolio
Manager

Capturing Elevated Yields Without Longer Duration or Lower Quality

KEY POINTS

- 1 We expect credit spreads to remain range-bound in 2023, limited by macro uncertainty, while the anticipated lack of economic destruction means spreads are unlikely to make new wides.
- 2 We believe investment grade credit yields are at levels that meet investor goals, without the need to extend duration or move down in credit quality.
- 3 Uncertainty is expected to decrease as central banks pivot to a more balanced policy mix focused on growth and inflation, and cost increases become less challenging for corporate planning.

What We Are Seeing

- Four themes are dominating the credit debate:
 - Geopolitical challenges—Ukraine conflict, deglobalization, sustainability—have triggered supply-side disruptions and higher inflation.
 - Zero-COVID policies in China have led to lower global growth expectations.
 - As central bank policies have shifted to fighting inflation with tightening financial conditions, markets are focused on a potential policy error.
 - Corporate profitability is under pressure from cost increases, and aggregate demand is expected to fall, resulting in increased defaults.
- Many recent trends look positive for credit, including signs of moderating U.S. inflation, supply-side relief in Europe and a potential reopening in China, with lower energy prices. As a result, valuations have moved to the tight end of our expected range—just above the long-run average—for investment grade credit.
- Overall, we see companies entering 2023 with defensive business models, strong liquidity and optimized costs of production thanks to efficiencies implemented during the COVID era. We also see lower leverage that considers the risks to corporate profitability in 2023.
- Markets are expecting a recession in 2023, as signaled by the inverted, risk-free yield curves. However, with employment remaining strong, nominal growth is expected to be positive. Moreover, with generally strong consumer balance sheets supported by the fiscal stimulus under COVID, we expect a “different” recession, where default rates do not spike.

What We Are Doing

- We look to capture elevated investment grade credit yields, which we believe are at levels that can meet investor goals without the need to extend duration or move down in credit quality.

- We expect credit spreads to remain range-bound in 2023 and are positioning accordingly. We see macro uncertainty limiting the upside of credit ranges beyond their long-run averages. Moreover, we think the lack of economic destruction in a different recession effectively restricts credit spreads in making new wides. We look to carry¹ as a driver of returns, with yields at attractive levels.
- We are positioned to favor U.S. revenue streams from issuers with bonds denominated in euros. Growth looks more robust in the U.S. than in Europe, but wide swap spreads and attractive cross-currency hedging favor euros.
- We expect the financials sector to outperform in 2023, as the weakness in 2022 created by heavy supply and recession concerns continues to abate.

What We Are Watching

- **Supply-side disruption.** We expect economies to adapt to the “new order” with new energy supply sources, labor markets addressing shortages and technology advances limiting cost increases. These trends should result in lower inflation in 2023.
- **Central bank pivots and monetary policy.** In an environment of lowering inflation, central banks are likely to pause their tightening cycles, while maintaining optionality for future moves. If this occurs, it should reduce the tail risk for markets—a positive for credit spreads.
- **China growth.** Recent headlines announcing policy developments related to a 20-point plan to address the COVID reopening and a 16-point plan to support the housing sector signal the marginal news may be positive in 2023.
- **Corporate defaults.** Markets are ending the year wondering whether expectations of a spike in default rates is too pessimistic. Looking forward, for credit to perform well, we don't need good news, just better-than-expected news.
- **Sustainability.** Focusing on ESG could bifurcate between those measuring impact and those centered on financial returns, while still considering sustainability factors.
- **Technical.** The market is sensitive to supply and demand expectations, which reportedly are conservative.
- **Valuation.** European spread underperformance in 2022 reflects the widening of swap spreads and weaker credit markets. Outperformance in 2023 should come from swap spread tightening as German government supply increases.

“Many recent trends look positive for credit, including signs of moderating U.S. inflation, supply-side relief in Europe and a potential reopening in China, with lower energy prices.”

¹ Carry refers to a strategy that involves two different positions, where the inputs end up being greater than the outputs.

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PRIVATE REAL ESTATE



Tony Charles
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Investing

Strong Fundamentals Offset Capital Market Weakness for High-Quality Assets

KEY POINTS

- 1 Strong fundamentals continue to offset capital market weakness for high-quality assets, even as capital flows back into equities and fixed income.
- 2 On the horizon are more dynamic and highly leveraged markets, ESG retrofit opportunities to optimize asset energy efficiencies, and arbitrage between public and private markets and funds seeking liquidity.
- 3 We see potential for distressed or forced selling in the weakening environment, as well as increased M&A activity between public and private companies.

What We Are Seeing

- Real estate fundamentals generally remain strong and are helping to offset capital market weakness for high-quality assets. New construction on projects that haven't begun has stalled, bolstering fundamentals over the intermediate term. Meanwhile, embedded rental income growth should help to protect values amid a weaker macro backdrop. Industrial and residential fundamentals are leading, buoyed by record-low vacancy and secular tailwinds such as eCommerce and high rentership.
- Investors are increasing allocations to niche sectors, such as student and senior housing, healthcare and self-storage, which have counter-cyclical demand drivers. Hotel recovery is accelerating for leisure and lagging for corporate. Hybrid office working models and more discerning occupiers are disrupting office demand. Inflationary headwinds continue to challenge retail real estate.
- ESG is growing in importance for investors, occupiers and employees, and is critical to optimize rent and asset value.
- Real estate transaction markets have stalled due to lower availability and elevated cost of debt, as well as heightened market uncertainty. Japan remains the exception, where financing costs remain at record low levels. Fund flows into real estate have slowed due to the denominator effect, which is shifting capital back into equities and fixed income as investors rebalance portfolios.

What We Are Doing

- Increased volatility and the pullback in market liquidity provide a more favorable environment for investors who have capital to acquire high-quality assets in preferred sectors with robust fundamentals, at a reduced basis.
- We are targeting more dynamic and highly leveraged markets where re-pricing is expected to be fastest due to higher debt costs (U.S., UK, Australia, South Korea), and we continue to use existing relationships to acquire assets at an attractive basis in Japan. We're also considering credit opportunities, including gap financing through mezzanine/preferred equity positions.

- We are taking advantage of the arbitrage between public and private markets and funds in need of liquidity. We are seeking the highest quality assets that meet post-COVID-19 occupier requirements. We are looking to leverage asset management expertise to drive income growth. Moreover, we are targeting ESG retrofit opportunities to optimize asset energy efficiencies.

What We Are Watching

- We are observing how economic, employment, inflation and interest rate signals may inform cyclical market turning points. We are on the lookout for signs of distress or forced selling in the weakening environment.
- We are anticipating increased M&A activity between public and private companies.
- We see potential for heightened regulatory risks—such as rent control and real estate taxes—from the shifting global political environment. We have our eyes on global dislocation, divergent recovery cycles and different opportunities by region and market. U.S./China geopolitical tensions and the impact on global growth and supply chains continue to add pressure across equities, and we are waiting to see how that impacts private real estate.

“We are observing how economic, employment, inflation and interest rate signals may inform cyclical market turning points. We are on the lookout for signs of distress or forced selling in the weakening environment.”

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PRIVATE EQUITY



Patrick Reid, CFA
Alternatives
Specialist

Record Levels of Dry Powder and Earnings Propel Private Equity

KEY POINTS

- 1 Earnings serve as the engine of growth in private equity, accounting for nearly half of value creation.
- 2 Rising interest rates may lead to reduced leverage and lower multiple expansion.
- 3 Dry powder remains at record levels of \$3.6 trillion and should fuel high transaction volume.

What We are Seeing

- Earnings growth is likely to be the principal driver of PE returns ahead, and manager selection will remain key, with experts in profitability-enhancing operational improvements and strategies that capture synergies best placed to generate alpha.
- Leverage's contribution comprised roughly one-quarter of total Multiple on Invested Capital (MOIC), only slightly behind multiple expansion.
- Higher borrowing costs and less buoyant IPO and strategic buyer demand are hindering multiples.
- Monetary tightening, fiscal retrenchment and supply-side disruptions are shrinking global demand. The economic slowdown, coupled with higher inflation and rising interest rates, has pushed global equity markets into bear market territory. Rising interest rates may trigger reduced leverage and lower multiple expansion, limiting the contribution to performance from these key return levers.

What We are Doing

- We emphasize capturing value at entry in transactions because in an environment of rising interest rates, we don't expect multiple expansion to drive returns as much as it has over the past 20 years.
- Buy-and-build strategies are key to unlocking stronger revenue growth and maximizing operational efficiencies, as they help to grow scale and capture synergies. This investment approach is repeatable and often enables add-on acquisitions at below headline valuation multiples.
- We're staying the course as PE absorbs market dislocations and capitalizes on interesting entry points. PE is showing the most growth potential among private asset classes and is on track to account for nearly 70% of alternatives AUM by 2025, according to Preqin.¹ We continue to build on PE's exceptionally robust performance over the past decade.
- We focus on profitability-enhancing operational improvements and strategies that capture synergies best placed to generate alpha.

What We are Watching

- General partners (GPs) must implement best-in-class operations and capture synergies and scale through strategies such as buy-and build.
- Fundraising may slow, but dry powder remains at record levels of \$3.6 trillion, which should sustain high transaction volumes. Amid continued competition for quality assets, deal origination at attractive value-at-entry levels is not a given, and GPs must remain selective and disciplined to create value.
- Earnings become increasingly important as a source of value creation due to multiple compression and rising debt costs. Investors continue to increase their allocations to alternatives to meet their long-term investment objectives.
- Partnering with founders in the midmarket—particularly those seeking support from financial investors for the first time—and reducing operational vulnerabilities may make businesses less sensitive to economic headwinds.

“Amid continued competition for quality assets, deal origination at attractive value-at-entry levels is not a given, and GPs must remain selective and disciplined to create value.”

¹“The Future of Alternatives 2025,” Prequin, August 2020.

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INDEX DEFINITIONS

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

Russell 1000® Value Index is an unmanaged index of U.S. large cap value stocks.

Russell 1000® Growth Index is an unmanaged index of U.S. large cap growth stocks.

Russell 1000® Index is an unmanaged index of 1,000 U.S. large-cap stocks.

Russell 2000® Index is an unmanaged index of 2,000 U.S. small-cap stocks.

Russell 2500® Index is an unmanaged index of approximately 2,500 U.S. small-cap and midcap stocks.

Russell Top 200 Index measures the performance of the 200 largest companies in the Russell 1000 Index.

MSCI World Index is a market-cap weighted index that captures large and mid-cap stock performance across 23 developed market countries.

MSCI Emerging Markets Index is an unmanaged index of emerging markets common stocks.

FTSE Nareit All Equity REITs Index is an unmanaged index of real estate investment trusts not designated as timber or infrastructures.

Morningstar LSTA US Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

ICE BofA U.S. High Yield Index is an unmanaged index of below-investment grade U.S. corporate bonds.

ICE BofA U.S. MBS Index is an unmanaged index of U.S. mortgage-backed securities.

Bloomberg Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Bloomberg U.S. Corporate Bond Index is an unmanaged index that measures the performance of corporate securities issued in the U.S.

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