The Federated Hermes 2023 Outlook

Our investment experts on the eight themes that will matter next year

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Foreword

"Events, dear boy, events." So replied Harold MacMillan when, on becoming British Prime Minister in 1957, he was asked what would determine his government's course.

His answer would be equally appropriate if we were asked what defined 2022.

It has been a year which has been dominated by events.

Geopolitics has been at the forefront – particularly the effects felt as a result of the war in Ukraine – which has had an effect on inflation, on energy and, ultimately, the cost of living.

COP 27 in Egypt and the Biodiversity-focused COP 15 in Canada both helped to bring the crisis in Biodiversity to prominence, but there is lot of work to be done if we are to see change.

Related to that, it has been a rough year for ESG, with politics and a wide misunderstanding of what it is and what it means in the context of investing, playing their part to muddle the landscape.

Tech companies have had a tough year, falling out of favour with investors, but we think there are some great opportunities outside the US, particularly in Europe.

You will be pleased to know that all these topics are addressed superbly by our investment experts at Federated Hermes in this year's Outlook. And there are plenty of silver linings, in case you are concerned.

2022 was a tough year. I hope that 2023 will bring a bit of order, a bit more certainty and lot more progress in resolving many of the challenges that emerged in 2022.

Saker Nusseibeh, CBE
CEO

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Inflation

Fraser Lundie
Head of Fixed Income – Public Markets

The trouble with opining on inflation is the short-term noise, much of it backward looking, leaving both investors and central bankers in a difficult position to champion long termism. But forward curves are informative, showing the market has priced in the risk of inflation staying higher for longer. Yet, the prospect of inflation falling further and faster than current forecasts suggest has not been fully priced in.

At present, the expectation is for price rises to stabilise from Q1 2023 but for inflation in most developed economies to remain above central bank targets. There are multiple factors shaping this prediction: firstly, greater pricing power for companies as consumers begin to accept inflation-driven price rises. Secondly, deglobalisation – reshoring supply chains, for example – and the workforce starting to target real income levels. There may also be an element of fiscal outspend being reflected, keeping inflation stubbornly high. Even longer term, demand for investment in the energy transition is inflationary – as is a lack of investment in carbon-heavy forms of energy generation which will have its own impact on supply.

So, the case for a higher-for-longer inflationary scenario is a totally reasonable one, but we must also consider the alternatives. For one thing, the outlook is massively complicated by the nexus between fiscal spending, energy pricing and monetary policy. There are few if any comparable periods in history to garner insight from, as well as other unknowns that have to be factored in. Financial stability, for instance, is an obvious concern. Depending on how things play out, we might witness a destabilisation of markets and a fall in asset values, which would be disinflationary in the short term.

But the potential for disinflation is very real in mid- and long-term scenarios too. Take a secular stagnation scenario. Has that been written off too soon? Sure, we might be seeing a change from what we've experienced over the past decade or so – but is it wise to entirely discount the effects of ageing and shrinking demographics on aggregate demand? Or the impact of advances in on aggregate supply? These mega trends must not be forgotten as we strive to maintain a long-term approach to investing.

Geir Lode
Head of Global Equities

In 2021-2022 many countries experienced the highest inflation rates in decades. High inflation is regarded as harmful to the long-term prospects of an economy. Recent high inflation has been attributed to various factors including fiscal and central bank policy responses to the pandemic in 2020-21, supply shortages arising from increased consumer demand and pandemic-related supply shocks, a tight labour market reflecting shifting worker preferences, and the Russian invasion of Ukraine and its effect on energy and food markets.

The policy-relevant debate about whether inflationary pressure is transitionary or persistent hinges on both a discussion of the likely trajectory of these underlying factors, as well as arguments about whether workers and firms are developing more entrenched expectations of higher future inflation. As long as inflation rates continue to increase, or fail to fall sufficiently quickly, central banks will not hesitate to increase interest rates, even if the result is a recession. We are seeing easing of the goods shortages alongside a sustained increase demand for services in the immediate aftermath of the pandemic. While there are signs of softening future demand, we are unlikely to see a return soon to pre-pandemic conditions; economies will need time to adjust to the higher demand for services and increased labour costs before inflation will start to recede.

There has been a lot of attention paid to the short-term inverse relationship between inflation and stock returns. However, over the long-term, stocks have provided an inflation hedge. Often investors focus on nominal yields rather than real yields when valuing cash flows. Value stocks with high current rather than future yields tend therefore to perform better when inflation is high. Indeed, value stocks have outperformed growth stocks by a wide margin this year.

Although there are signs that inflation may have peaked in the third quarter, in most markets CPI is still above what the Central Banks would be comfortable with. Interest rates will peak higher next year than investors previously envisioned, and then decline. Stocks prices historically have adjusted 12-18 months ahead of interest rates. Investors should therefore start to position their portfolios into growth stocks. Stocks with both high expected earnings growth and sustainable low-carbon business models have lagged the market this year by a wide margin. This is an excellent opportunity for the long-term investor to buy these stocks at very attractive prices.

Kunjal Gala
Head of Global Emerging Markets

Although emerging markets underperformed the developed world in 2022, the performance of EM ex-China is in line with the developed world. While China deals with its unique challenges, emerging markets generally have shown resilience despite rising inflation. 2022 is perhaps the first time in recent history that inflation in emerging markets is lower than in the developed world. Due to years of loose monetary policies, growing fiscal deficits, shrinking workforce, and structural imbalance due to welfare policies, the developed markets were always vulnerable. The crisis of the last few years has exposed the vulnerability with higher than usual inflation as a by-product of the structural issues.

Contrary to the developed world, EM policymakers are used to dealing with inflationary environments and a certain degree of market volatility and have pursued prudential macro policies. As global central bank action suppresses demand, the world will emerge from the initial inflation shock, and the markets will rebound in 2023. However, the challenges of decarbonisation, deglobalisation, and deteriorating developed world demographics will continue to drive inflation and change in developed economies. In particular, the developed world's supply-side vulnerability will likely result in medium-term inflation settling higher and growth at lower than historical levels. We expect inflation to be less of an issue for emerging markets due to favourable demographics, manufacturing capability, availability of critical resources, and focus on supply-side reform/infrastructure.

Medium/long term, we anticipate a shift in the investment environment that will likely be decisively different from the last ten years. There is a likely change in the regime as investors evaluate the impact of higher-than-normal inflation and cost of capital with sticky supply-side constraints (energy, commodities, and workforce). The shift will likely create winners and losers at global, regional, and sectoral levels. Emerging markets have a golden opportunity to improve their competitiveness as inflation levels the playing field globally. Emerging markets can capitalise on leadership in growth, workforce availability, manufacturing prowess, and resource availability. We expect several emerging markets to benefit substantially from a relocation in supply chains which has already begun. In contrast, the developed world is learning to adjust to high inflation and is distracted by structural challenges investors are now considering.

Patrick Marshall
Head of Fixed Income – Private Markets

As the ECB seeks to subdue inflation's upward trajectory by hiking interest rates, direct lenders are set to attract investors through higher potential returns given the floating rate nature of underlying loans. As base rates go up, so too does the yield on a loan.

Alongside this, with so much uncertainty hanging in the air, lenders have taken a more risk-off approach, with N. European yields moving up c. 65bps to date, while leverage levels, for senior and unitranche, are coming down. We expect this trend to persist through next year as lenders take a more conservative view due to weaker macro conditions.

While yields look promising, we can't ignore that inflation could impact the underlying borrowers in direct lending portfolios next year. Considerations of a borrower's ability to pass through additional input costs, exposure to energy costs and how a reduction in consumers' discretionary spending will impact a borrower's earnings are only some of the items that will remain under the microscope as managers seek to navigate 2023.

With so many unknowns, we expect managers and acquirers to retract slightly from new market activity while parties assess what constitutes accurate pricing, leverage and valuation multiples in this new environment. This hiatus of new deal activity is more likely to resemble a pause rather than a shut down due to private equity's bumper cache of EUR344.3bn that needs to be deployed.

For those managers more exposed to retail, leisure and energy intensive sectors, it might be that resources get redirected towards restructurings and underperforming assets, allowing better positioned managers to gain market share. Refinancings of current debt packages are likely to be few and far between, with activity dominated by add-ons and amend-to-extends. Business services, healthcare and TMT are likely to remain the most sought-after sectors.

Next year will however present opportunities for those managers who are unburdened with problem assets in their current portfolios, as they compete against fewer competitors and have more negotiating power on margin, fees and documentation due to a reduction in available capital.

While inflation levels of this extent are denting consumer confidence and stifling businesses, for now, a heightened awareness and a cautious attitude is likely to descend on the direct lending market.

Geopolitics

Silvia Dall'Angelo
Senior Economist

Geopolitics was a key driver of economic dynamics across emerging and developed countries in 2022; 2023 is just likely to see a continuation of that trend.

The war in Ukraine has been both a manifestation and an accelerator of pre-existing geopolitical trends. For some time, relations across countries and blocs had become more fraught, pointing towards a more fragmented and unstable international regime. Domestically, most countries have adopted a more inward-looking stance, with populist and protectionist views and policies gaining traction across the board. The economic consequences of a more unstable geopolitical backdrop will be significant and will play out over extended horizons, in a non-linear fashion and with significant feedback effects between economic and geopolitical developments.

In the short-term, the increase in commodity prices triggered by the war in Ukraine has contributed to a deterioration of the inflation outlook globally, in turn resulting in an erosion of real incomes and tighter monetary policies. A pronounced slowdown in global growth is in the cards for 2023. In particular, the energy price shock that originated from the war in Ukraine has resulted in the worst cost-of-living crisis since the '70s in Western Europe, which is likely to lead to a recession starting at the turn of 2022.

Looking beyond 2023, current geopolitical trends will likely bear on the prospects for globalisation, the main source of productivity gains globally in the last decades. Policymaking will be increasingly driven by national security considerations rather than economic rationale, distorting business decisions. Specifically, the recent double shock from Covid and the war in Ukraine sharpened policymakers' focus on supply chain resilience, energy and food security. Those goals will develop over a long period of time and will come at a cost. Supply chain resilience will call for a mix of supply chain duplication, on-shoring, and friend-shoring. While the process will likely develop gradually and opportunistically, it will be inflationary as it will imply higher costs and efficiency losses.

As a silver lining, the goal of energy security strengthens the case for the green transition. In the short-term, the energy crisis will drag on the prospects for the green transition, as the need to secure energy supplies outweigh carbon intensity considerations. However, in the longer-term, the development and scaling of renewable sources offers the most promising solution to achieve secure and cheaper energy, especially for net importers of fossil fuels like Europe.

Mark Sherlock
Head of US Equities

Geopolitics in 2023 (and beyond) will be dominated by ongoing deglobalisation. This trend has its origins in supply chain disruption caused by Covid where the shortcomings of 'just in time' global supply chains were laid bare. More recently, Russia's invasion of Ukraine and the subsequent 'weaponisation' of fossil fuels has shone a light on countries' energy security and their dependence on energy from – in many cases – politically unstable or expansionist regimes. As a result, many conclude that peak globalisation has passed, to be replaced with a much more myopic, domestic focus.

This emerging nationalism has myriad political and economic implications. Those countries rich in natural resources, for example, may decide that now is a good time to push their interests forward more forcefully. Knowledge-based economies will limit the amount they share with others – witness the US government's bill around the export of semi-conductor equipment. This 'each for themselves' approach is emboldened by domestic concerns – a polarised electorate, increasing inflationary pressures, a cost-of-living crisis and the very real spectre of recession. A lack of co-operation and suspicion of other nations is likely to characterise global behaviour.

With regards to the US, the mid-term elections in November 2022 resulted in a divided government. While the policies and funding contained within Biden's flagship Inflation Reduction Act appear safe, little new legislation of note – either internal or focused internationally – is likely over this President's remaining term. Upside surprises in 2023 could come from an acceptable resolution of the conflict in the Ukraine, Chinese re-opening (and the economic prosperity that entails) shifting the focus away from expansionary politics and incrementally better economic news in Europe. Over the medium term, the rise in importance of the Middle East will become increasingly clear to the global community.

Energy

Martin Todd
Sustainable Global Equity Portfolio Manager

Despite a market down more than 20% this year, energy continues to soar. The sector has remained top performer within Global equities for the second year running, posting a 30% gain in 2022.

Driven by energy security concerns with the ongoing conflict in Ukraine and demand underpinned by re-opening post-Covid, not only is energy creating divergence in market performance, but also value. With notable profit upgrades, energy remains the cheapest GICS sector trading on a prospective 8x earnings with and expected dividend yield >4%.

As the saying goes, the cure for high prices is high prices. Both in reducing demand and luring in new supply as new entrants compete away super-normal profits. Some level of demand destruction is likely – in NW Europe, BNEF is predicting a 17% drop in demand this winter vs the 2016-2020 average. Supply, however, is also limited and OPEC's October production cut is likely to underpin prices, much to America's chagrin.

In 2023, we expect headline costs for renewable energy to continue to decline and the build-out of both solar and wind to accelerate in pace. There is, however, no escaping the dependence on fossil fuels within the global energy mix, nudging up to ~82% vs ~81% in 2021. More concerningly, coal powered energy has risen to record levels in 2022 (IEA), as energy security took precedent over decarbonisation.

This tug of war between supply and demand in global energy markets are somewhat consequential of conflicting time horizons. Sound energy policy requires a multi-decade strategy, mis-aligned with 3-5 year political cycles in much of the West. Political mixed-messaging hinders planning and windfall taxes on profits could deter long-term investment in an industry that's already scaled back capex materially in recent years.

For equity investors there is clear value in Energy, albeit with need to be weighed against political risk, namely windfall taxes. Clean energy sources will continue to be increasingly cost competitive next year, and we expect more opportunities in the space as the pandemic supply chain problems dissipate, and higher energy prices encourage greater adoption.

Mitch Reznick
Head of Sustainable Fixed Income

From the start of 2019 through the end of October 2022, non-financial corporates issued some $730 billion of green and sustainability bonds. The Energy sector comprises some 10% in count and around 6% in volume of that total issuance through that period. And while that is not terribly material, there is a very interesting trend that lies beneath.

Based on common sense, one would think that all or nearly all sustainability bonds in the energy space would be issued by renewable energy companies. That was the case in the early years of this brief period of time. In 2019 and 2020 fewer than 10% of issuers of labelled bonds in the Energy sector came from non-renewable sub-sectors (e.g., Refining & Marketing, Integrated Oil). However, something happened during the surge in sustainability bond issuance of 2021. Suddenly nearly 50% of issue volume in the Energy sector came from such non-renewables as Coal Operations, Pipeline, and Exploration & Production. This trend carried into 2022 when non-renewable green and sustainability bonds reached some 62% of Energy-sector volume. How did the composition of the Energy sector's composition of non-renewables go from around 10% to over 60% in a short period?

In the period prior to COP26 in the autumn of 2021, the global exuberance for decarbonisation spilled into the capital markets. As shown by the surge in companies that had their decarbonisation targets approved by the Science-based Target Initiative, companies wanted to signal to the capital markets that they were serious about reducing their carbon footprints. As such, issuers needed to finance these objectives and were easily able to issue labelled bonds into a market keen to invest in positive change. Coal miners, pipelines, and exploration-production companies dropped onto that wave and sold green and sustainability bonds. Of course, the observed "greenium" on offer made for an attractive drop-in as well.

We have no reason to expect that this trend won't continue into 2023. We will listen to the case that the sustainability financing is a catalyst to greener pastures into the future for an Energy issuer. However, unless the financing is leading to a credible transition or material decarbonisation of the issuer, we struggle with a sustainability financing from companies, that, for example, generate some 90% of their revenue from coal operations. Sustainability financings in the non-renewable Energy space have great potential, but we suggest reading the large print on the label.

Perry Noble
Head of Infrastructure

Global energy prices have experienced a period of extreme volatility following Russia's invasion of Ukraine. The invasion exposed Europe's reliance on Russian commodities leading to a renewed focus in the EU and UK on security of supply. Elevated energy prices are contributing to broad based inflation that is increasing the cost of living. Affordability is a significant challenge for many households.

In response, governments' ambitions globally to build resilience and reduce reliance on imported energy have increased markedly. Fundamentally, this should be a positive development for achieving Net Zero. Delivering a low-carbon energy system critical for the transition to Net Zero – installation of new wind and solar power capacity; electrification of transport; increasing blue and green hydrogen production and utilising utility scale Carbon Capture Usage and Storage (CCUS) projects – also reinforces security of supply and contributes to reducing reliance on volatile commodity prices. This, coupled with a need for infrastructure to manage the impact on the system of an increasing proportion of intermittent renewable power generation, should broaden the potential investable market for private capital.

We see this trend continuing throughout 2023 and the next decade as the requirements for markets and governments, driven by carbon pricing and more ambitious climate commitments, accelerate the path to decarbonisation. By 2050, widespread adoption of technologies that are not yet on the market, as well as significant additional deployment of proven technologies, will be required to meet Net Zero ambitions. Major innovation efforts must occur in the near term in order to bring these new technologies to market in time to meet the 2050 deadline.

There is a risk however, that rushed, short-term decision making, intended to support households and businesses during a period of high energy prices, inadvertently deters private capital from making the long-term investment commitments required to support the transition to Net Zero. Investors respond positively to carefully considered pricing models designed to promote essential new technologies, which they can rely on. Whilst they react negatively to policy uncertainty and drift. Devising a path that successfully addresses the short-term challenges faced in the current macroeconomic environment, whilst avoiding compromising what is required longer term to combat the climate emergency, will be critical to the outlook for energy markets globally.

Tech

James Rutherford
Head of European Equities

It's no secret that tech, along with the majority of the market, has experienced its challenges this year. Apple is on hiring freeze, Amazon, Twitter and Meta are laying off staff and the sector has been punished with major losses. With eyes mostly on the US, we suggest looking to Europe where we are bullish on the sector for 2023.

Indeed, the European and global MSCI technology indices have declined and significantly underperformed their broader market indices in 2022 year-to-date.

Some of the year-to-date decline is justified and driven by weak volumes of smartphones and PCs as well as fears of a correction in general IT spending. The other (and we suspect, more significant) contributor to the YTD tech sector declines is the rise in interest rates.

Technology stocks are usually classified as 'growth' stocks, with the bulk of their intrinsic value contained in the 'terminal' time periods; thus an increase in nominal interest rates usually tends to have a disproportionately damaging impact on the prices of 'growth' stocks such as those in the tech sector. We have also seen that 'value' stocks (and associated sectors such as commodities and energy) have been big relative winners on the other side of this rebalancing.

When the investors time horizons shorten, technology underperforms; and when time horizons lengthen, technology outperforms again. In our view, 2022 so far is clearly characterized by short-term market mood swings. We are leaning against that wind. Despite the current macroeconomic and geopolitical uncertainties, our eyes are firmly on the longer-term secular themes which we believe will reward the technology sector with substantial alpha. These trends include the rise of AI, automotive electrification, cloud adoption, and industrial decarbonization.

We hold shares in several European technology companies that play indispensable roles in driving these trends. On most valuation metrics (including balance-sheet focused measures), we believe the recent price drop has brought the technology sector back to the valuation levels of 2018/19. We therefore expect quite attractive medium- and long-term IRRs from our technology sector investments, and 2023 can contain a lot of that short-term outperformance.

Peter Gale
CIO, Private Equity

2022 was a year that took some air from the tyres of global financial markets and brought a gravitational pull back to valuations. Looking ahead, we expect 2023 to be a year in which dynamic companies and investors adjust and adapt to structurally higher inflation and interest rates.

The pandemic catapulted organizations into the future with the workplace changing overnight and today's macroeconomic backdrop is driving businesses further to innovate and embrace technological change. We review hundreds of investment opportunities in the mid-market and lower mid-market globally and the pace of technological and business model innovation continues to accelerate. Pressing issues that companies face, from rising labour and commodity prices to supply chain disruption, are an impetus to build more agile and efficient operations, improve transparency and make better use of data. Companies that provide tech infrastructure and solutions to boost productivity can build profitable models with strong unit economics, even in a tough macroeconomic environment.

Geopolitics is also pushing companies to reorganise supply chains to be more resilient, efficient and sustainable. In 2023, we expect to see investment opportunities continue to arise from near-shoring trends, supply chain digitalisation and 'just in case' inventory models replacing 'just in time'.

2023 will be a formative year for innovative, growth-oriented companies, and the investors backing them, and we expect to look back and marvel at the variety and criticality of technologies and solutions brought to the market.

While turbulence and disruption are a bedrock for innovation, the prism though which investors – in private equity, in particular – assess deals is also shifting. Business model and company quality is coming into greater focus, with more scrutiny placed on margins, cash flows and pricing power. We expect the bifurcation of valuations to continue in the new year with strong, structurally profitable business models on one side and those with weaker unit economics on the other. In the year ahead, it will be more important than ever for private equity firms to rely on experienced investment teams to maintain a selective, disciplined and proactive approach.

ESG

Leon Kamhi
Head of Responsibility

It is odd that having entered the investment industry's lexicon all the way back in 2006 with the launch of the Principles of Responsible Investment (PRI), it feels like ESG was never more misunderstood than in the year that passed. Further, the weaponization of ESG by both its promoters and detractors for commercial or political purposes went to new levels and views on ESG became highly polarised. In the meantime, well-intentioned regulators seeking to protect investors and get a grip on greenwashing have likely added to the turmoil with unclear and significantly burdensome requirements which are unlikely to help develop a sustainable economy.

2023 is likely to bring more of the same. Still, an alternative outlook would be to see investment responsibly working to support the creation of wealth for investors – sustainably. Investment with a laser focus on the interests of investors and undistracted by political aims or virtue signalling. Firstly, ESG to be seen for what it is, three distinct categories of performance drivers which historically were too often ignored in investment decision-making. To achieve any investment mandate's risk and return objectives, the material factors need to be considered.

Secondly, that in secondary markets it is the improvement of performance of the key economic drivers, including relevant ESG considerations, that matter to the wealth of the investor, not the existing quality of what is invested in. Investment management can support this through effective stewardship. This form of ESG investing is distinct from investing in high ESG performing investments in line with a set of values rather than for the creation of value.

Thirdly, that the focus of regulation of responsible investment moves away from simply capturing 'sustainable' secondary investments to be what is already green. Instead, regulation should properly recognise the role which stewardship plays in delivering sustainable outcomes and the enhancement of an investment's performance.

Biodiversity

Eoin Murray
Head of Investment

Hot on the heels of COP15 and an acceleration in action, 2023 is going to have a lot to live up to.

The end of 2022 has seen notable progress on biodiversity issues such as the successful launch of the Global Biodiversity Framework, the International Union for the Conservation of Nature's (IUCN) proposal to establish 'nature positive' for biodiversity akin to 'net zero' for climate, and Uruguay's successful issuance of the first ever sovereign sustainability-linked bond with a 'nature' KPI embedded within it. We must not lose this momentum heading into next year.

But there are already plenty of reasons to remain optimistic, with the beta framework of the Taskforce for Nature-related Financial Disclosures (TNFD) still open for comments and feedback until June next year, and with final publication of the complete set of recommendations expected in September. All of which point to a growing realisation that tackling climate change alone will be insufficient, and that a robust response to the imminent dangers of biodiversity and ecosystem loss is also essential.

While we are rightly proud of our contributions in the public equity and real assets worlds thus far, we have further to go to deepen our scrutiny of the link between environmental risks and economic and financial outcomes, with respect to both impacts and dependencies. We remain supremely conscious that for many countries nature loss is a critical threat to debt sustainability and we anticipate that nature loss will have a significant impact on credit ratings. Accurately measuring and reporting nature-related financial risks forms a strong foundation for safeguarding biodiversity. However, we will continue our efforts to offer investors a meaningful entry point for the deployment of capital to take advantage of the opportunities afforded by the restoration of nature and placing it at the heart of our economic system.

Our health, wealth and security depend on the healthy state of our natural capital. Tackling nature loss and climate breakdown together is both an economic imperative and a fiduciary duty. If we "direct financial flows" towards those that protect and restore nature, the financial system can drive the transition to a more equitable, net zero, nature-positive global economy.

Ingrid Kukuljan
Head of Impact and Sustainable Investing

The biodiversity crisis, which has largely been ignored by investors and corporates thus far, is about to take centre stage. Following COP15 in Montreal in December, we believe 2023 will put the deserved spotlight on nature and biodiversity.

The invisible crisis has become an everyday occurrence, showing its fangs through fires, droughts, floods and is forcing the society, policymakers, corporates and investors to wake up to the fact that we are beyond the tipping point. We have already altered 75% of the earth's surface and 66% of the marine environment, just to satisfy our consumption and energy needs. The global population is set to reach 10 bn in the next 20-30 years, implying an increase in food demand of around 60% and energy by around 80%. This will be difficult to achieve, as we are already using resources which are scarce so we need to focus on halting and reversing biodiversity loss through conservation and replenishment.

Looking ahead, we are likely to see a continued increase of physical risks highlighting the urgency for action. The continued droughts, flooding and wildfires have enormous impacts for food production and water security. The alarming situation should help raise awareness of our dependence on nature and ecosystem services.

This should translate to policy and regulation implementation by national governments on a range of different areas such as deforestation, sustainable agriculture, waste and water. We would hope to see a potentially mandatory disclosure of impacts and dependencies on biodiversity across counties, especially those ones which are biodiversity rich such as Australia. Brazil has already taken steps forward - at COP27 in Egypt President-elect Luiz Inácio Lula da Silva vouched to fight illegal Amazon rainforest deforestation, a stance he took during his leadership between 2003-2010.

From an investment perspective, the final draft of TNFD to be published in the latter half of next year will guide reporting on biodiversity by companies. Whilst it may take some time to produce a high standard of reporting, this is a positive step for investors as it helot them to assess companies with more clarity. We also expect biodiversity to be a key engagement issue addressed alongside climate change. As with Finance for Biodiversity and FSDA deforestation commitments, continued industry collaboration will be key to solving ongoing challenges.

China

Jonathan Pines
Head of Asia Ex-Japan

Investors in China have recently had many reasons to be bearish – zero covid and common prosperity policies, property market concerns, the potential delisting of US-listed ADRs and tensions with the US. To these has been added a further worry – a tighter grip by President Xi following his appointment of close allies to key positions. Although these appointments were not particularly unexpected, it has caused some investors to finally throw in the towel. The effect on markets was dramatic.

The key risk we are concerned with remains geopolitical – China's relationship with the US – rather than domestic policy driven concerns. China admittedly lacks the quick self-correcting mechanisms to domestic policy missteps more apparent in democracies. (Witness as a comparison, for example, recent events in the UK where the movements of currency and gilts markets were the impetus for quick political change). However, we do believe that there are political mechanisms that will nevertheless exert pressure on the authorities to act if a sustained growth slowdown threatens the economic wellbeing of its citizens. After all, the implicit bargain that the government has with its citizens is the acceptance of political restrictions in exchange for continuing personal economic improvement.

We believe that China's economy has stagnated significantly and this will now limit the will or practical ability of President Xi to adopt anti-growth or anti-business policies.

Chinese stock valuations are now probably at a record low relative to the rest of the world, with Chinese stocks listed in Hong Kong trading on a PE multiple of approximately 6 times. Very substantial risk has been priced in as investors focus on what could go wrong in China. However, things could also go right. Zero covid policies could be reduced or abandoned, a recent meeting between President Biden and President Xi has already resulting in a lessoning of tensions with cooperation between the US and China resuming in certain areas, China could unexpectedly adopt pro-business policies, the government could act more decisively to help the property sector, or adopt a massive fiscal or monetary stimulus (having the additional benefit of making it a global monetary-policy outlier).

We consider Chinese stocks to be too cheap. There are admittedly potentially geopolitical near-binary risks that might hurt investors investing now despite current cheap valuations. However, on a probability-adjusted basis we consider it a risk to be more than priced in and well worth taking.

Kunjal Gala
Head of Global Emerging Markets

China is at a crucial junction with multiple challenges including geopolitical rivalry with the US, outbreaks of covid and stress in the property sector to name a few.

These are immensely challenging issues that will test the resolve of the Chinese leadership. In any case, the debt-fuelled growth model of the past is irrelevant now and hence historical valuation is less meaningful. We are focused on how China is likely to evolve beyond the post covid re-opening trade. We believe that China can at best achieve a mid to low single digit real GDP growth considering the constraints under which the economy is operating.

Despite the challenges and issues, underneath the surface, the Chinese economy is undergoing a deeper transformation that is exciting and presents unique investment opportunities for long-term investors. In particular, we believe focusing on these themes will offer a long runway for growth in an economy that is largely ex-growth:

- Digitisation
- Renewable technologies / energy
- Biotechnology
- Financialisation of savings
- Metaverse
- Localisation of critical technologies

While the opportunity in these sectors is likely to be meaningful, it is important for investors to avoid pitfalls, some of which are unique to China. It is crucial to steer away from any sectors that can be associated with geopolitics such as the US entity list. In addition, we are avoiding companies in cyclical industries as these are typically loaded with excessive leverage and generate returns below their cost of capital. Over time, we believe that such companies will likely find the transition to net zero very challenging.

While China has made commendable progress in multiple fields, there is potential for the economy to achieve more. However, progress in the future will depend on the pace of economic reforms and further opening up of the economy. This will heavily depend on how quickly the Chinese leadership is able to reform its SOEs making them competitive and relevant for the future.

Globally, economies rarely cross the USD 10,000 per capita income without reforms at an institutional level. China has already crossed this level thanks to its previous growth model, focus on exports, and infrastructure. As some of these drivers unwind (property, excessive leverage), China will have to quickly assemble new drivers to sustain the income levels and ensure a higher quality of life for its people.

Mohammed Elmi
EM Fixed Income Portfolio Manager

From a credit investor perspective, the outlook for 2023 remains uncertain. Investors would have quite reasonably assumed that President's Xi's third term would herald a period of stability and policy continuity, but a number of issues remain unresolved and will weigh on Chinese credit spreads, despite compelling valuations from both an EM and global credit perspective.

The first of these, and similar to my equity colleagues' concerns, are the zero covid measures. At the 20th National Congress of the Communist Party the draconian measures were highlighted as a success in infection control, since then however, we have seen further tweaks to the policy followed by news reports of more lockdowns in a number of tier 1 cities. Our main fear is without a clearly defined infection control policy and a well-articulated exit strategy, 2023 will see a continuation of rolling lockdowns and interruptions in economic activity which will negatively weigh on growth.

Another drag on performance in 2022 has come from economic policy; piecemeal at best we look forward to more clarity in 2023. Keen to avoid the blunt instruments of large-scale fiscal and monetary expansion conducted during previous downturns, policymakers' approach has been hard to fathom. The hope for 2023 is that policymakers build out on the rhetoric of Common Prosperity and address the policy vacuum at the heart of this new philosophy.

The third major concern from credit perspective is the ongoing crisis in the real estate sector. Comprising of up to 25% of GDP, the housing market has a wide reach even beyond Chinese shores affecting global commodity prices such as the price of cooper, steel and iron ore. For context in 2022 the sector underwent what can only be described as a policy induced credit crunch, via the three red line policy designed to control and ultimately reduce debt in the sector. Sparking a credit crunch, developers found themselves unable to deliver on their projects and honour their Eurobond debt obligations. As a result, approximately 60% of the HY real estate Eurobond issuers have defaulted in 2022, and with no meaningful engagement with creditors on debt restructuring, prospects for the sector remain challenging and will weigh on sentiment in the wider Chinese corporate credit space in 2023.

Cost of living

Bruce Duguid
Head of Stewardship, EOS

Chris Taylor
CEO, Real Estate

Whilst governments and central banks work on economic and fiscal policies to deal with the cost-of-living crisis, EOS is integrating cost-of-living engagements as part of its wider stewardship programme. We are challenging companies on their role during this challenging time, with requests including an assessment of the impacts of their business model on their stakeholders and an articulation of the actions they can take to help support the most affected without damaging their long-term sustainability or further fuelling inflation.

Companies will need to balance the various pressures in their value chain and take appropriate action to steer a responsible course through the current crisis. We are encouraging companies to pay the real living wage, to think carefully about how they can support their employees with other benefits and exercise restraint over executive remuneration similar to investor expectations during the pandemic. Companies will need to work with their supply chain to ensure rising cost pressures are managed effectively so that quality of goods, worker standards of health and safety and conditions of employment are maintained. How increases in the cost of business are passed on to customers also needs balancing to retain the customer base, particularly of low wage consumers who will be looking to minimise costs of expenditure on basic goods.

Actions by companies to improve efficiency and mitigate the impact of rising costs will be more important than ever and will help reduce inflationary pressures, along with some specific sector actions, such as banks considering the impact of rising borrowing rates and the potential rise in defaults5, and utilities considering how to flex the cost of energy to minimise the impact on the most vulnerable. How food supply chains and supermarkets price their products and differentiate between economy products and higher-end products will also help ensure those most able to cope with rising costs bear more of the burden than those with more limited options.

How companies balance the trade-offs between rising operational costs, costs to consumers, profits, and pay-outs to shareholders will significantly impact the depth and length of the crisis. A well-communicated and responsible approach will be highly valued from a governance and risk perspective and should positively impact investment decisions and generate future brand value.

Since the low inflationary, low interest rate environment has come to an end, the question for UK real estate moving forward is how will this alter the way we live and consume and in turn, how will this impact the demand for the asset class.

As people's priorities shift, it will naturally lead to a bifurcation with some sectors such as build-for-sale housing, higher-end rented residential product and discretionary retail having reduced demand in the immediate term.

From an investor's perspective then, there is a need to understand where the opportunities exist within the context of three overlapping challenges. The first is that the public markets for a while have been telling us that real estate assets are expensive, with listed property companies trading at discounts to NAV of up to 50%. Second is the true nature of demand, and will it continue in this weak economic environment? So, we know there's not enough residential apartments, but can occupiers afford them? We know there is not enough high quality, carbon efficient office space in regional markets but we don't know how a forecast 2-year recession will impact demand for it. Third and finally, will my higher costs of construction and occupancy be compensated for by higher rental growth.

In terms of the buy-to-let residential sector ("BTR"), the rising cost of mortgages will make home ownership, already out of reach for a large portion of particularly first-time buyers, even less affordable. However, rising rents across the UK will lead to customers looking for value. Such value is unlikely to be found within poorly maintained private landlord accommodation where costs will no doubt be cut yet further to the detriment of the tenant or within the institutionally owned and managed, high end, high amenity, apartment blocks. Federated Hermes UK BTR operational platform, Hestia, has long championed the mid-market and its focus on affordability should continue to provide sustainable, low volatility, investor returns.

MEPC's programme of placemaking schemes in major regional cities continues to attract robust demand as corporates seek to attract and retain talent; city centre placemaking schemes which are community engaged, providing the halo effect of a well managed estate combining heritage, public realm, culture and accessibility alongside best in class offices, will prove resilient and relevant notwithstanding economic headwinds. Equally, thematic real estate investments such as those within the Oxford-Cambridge 'technology arc' which are life science related and technology based estates continue to attract strong occupational demand.

Our expectations are that the negative sentiment as evidenced by the listed sectors' sizeable discount to NAV will be felt in Q4 asset values, with continued volatility during H1 2023. Those investors who best understand and engage with their customer and occupier base will be better equipped to maintain their yield through this turbulent time and should be the first beneficiaries when rates and sentiment begin to improve.

Hamish Galpin
Head of Smaller Companies

Well known pressures on the cost of living are the result of the confluence of both short-term factors, such as rapid rises in the prices of materials, and longer-term factors such as the unwinding of low interest rate policies in place since the GFC.

The sad fact is that we, the consumers, have had a very long run of benign conditions, including the benefit to prices from the offshoring of manufacturing to low-wage economies and the low-price disruptive models of e-commerce players; e-commerce and credit have made it all too easy to consume, consume, consume.

In addition, low volatility in rates and central banks' efforts to reassure markets have numbed the consumer expectation and experience of volatile conditions, and this in turn has suppressed the feeling of "to save for a rainy day".

Whilst there is a need for consumers to adjust expectations, there is a current shock to spending for which markets must contend; retailers find themselves with excess stocks and mortgage applications have fallen sharply. Much of this has, however, been reflected in markets already with a material derating of exposed stocks in the first half of this year. Earnings, the focus in the second half of the year, have held up surprisingly well, and, whilst there may be some further weakness, valuations are now low enough (eg in auto companies and housebuilders), that the upside/downside risk mix is favourable for those that can ride out the storm (and in many cases be paid a decent dividend for their trouble).

The really difficult living conditions that lower income households, and those reliant on state benefits, will experience this winter will doubtless continue to feature prominently in the media, and dampen all our spirits. For markets, though, employment and pay are the key metrics to watch as discretionary spending is driven more by the upper cohorts, hence the importance of job numbers. It seems that the post-COVID demand for experiences is still very much alive, and this will be to the benefit of the Travel and Leisure market in particular.

In summary, whilst we are no longer enjoying such favourable conditions that lower interest rates and lower prices bought us in the last decade, consumer spending related stocks look to have priced much of this in and are not excessively priced currently.

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