Turning Points for 2023 - William Blair

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Olga and Hugo walk into the new year with an eye on potential trend shifts, such as the end of U.S. interest-rate hikes and a weakening U.S. dollar. They discuss China's reopening as a source of growth and consider what it might take to launch the next bull market in global equities.

Hugo: Hello, Olga. We've walked together through a tumultuous 2022, and now we're ready to peer into 2023. As you consider all the variables, what are you trying to forecast? What actually matters for investors?

Olga: Good question, Hugo. The world of investment has both excited me and humbled me. For global equity investors, what's important is to identify broad trajectories of growth and inflation rates, and then to forecast turning points, or changes in those trajectories. We assess the main factors that we think will affect where earnings growth is likely to head over one year or several years. I'm much less interested in precision; I think it's a fool's errand to put too much faith in point estimates.

Hugo: I'm especially interested in what you said about turning points. What looks different to you this year in terms of where we might find growth?

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Olga: Well, let's start by identifying a couple of macro variables where I think we're going to have a shift. And hopefully that will lead us nicely to where you and I think growth might be. The first trend reversal we need to talk about is the fed funds rate. The U.S. central bank is likely to stop tightening in 2023, perhaps in the first quarter, keeping rates stable around, in our view, 4.5% to 5%. Since we've been tightening for most of the past year, that will be a notable change.

The second likely big reversal is the depreciation of the U.S. dollar vis-à-vis other major currencies. If it materializes, that will be a sharp change in trend from the past several years of massive appreciation of the dollar.

Interacting with both of these potential shifts is China's reopening. It looks as though we're going to have another year of asynchronous post-COVID reopening. As a result, we are likely to get not only a boost in production but perhaps also a short-term boost in consumption and growth in and outside of China.

China's consumption today is 5% to 10% below the pre-COVID trend. As global investors, we need to think about the impact of 200 or 300 million Chinese consumers being able to travel again, which reminds me of the reopening frenzy that we saw in 2021 elsewhere in the world. China's reopening is probably going to be the biggest source of growth this year.

Hugo: I'm thinking about how China's reopening could affect global inflation, and it reminds me of the expression that the ball always bounces more than once. So, over the past couple of years, inflation rose, and the U.S. Federal Reserve (Fed) followed with its series of interest-rate hikes. Then inflation rolls over in the United States, if things play out the way we expect, and the Fed likely stops hiking.

But now, China reopening probably increases the demand for energy, which was a meaningful contributor to inflation in 2022. Doesn't that create, then, a second inflationary pulse?

> Inflation is moderating, and I think the trend in the United States is pretty well set.

Olga: I agree with you there, in terms of the ball bouncing more than once. Right now, inflation is moderating, and I think the trend in the United States is pretty well set.

In Europe, almost all of the inflation was due to bouncing energy prices and, more broadly, commodities. But I would venture that a lot of the run-up in energy prices had less to do with the demand for energy and more to do with an existential risk to Europe that energy wouldn't be available in the quantity that it needs. At that point, there's almost no price that is too high. This, incidentally, is what I think propelled the dollar to the dizzying heights that we saw in 2022.

That existential risk is likely off the table, barring some other geopolitical catastrophe. By and large, we have plenty of oil, and we have even more plentiful natural gas. At this point, it's a question of price, not a question of availability.

We don't think that China's reopening increases global demand for oil and natural gas beyond 4% to 6% above what was consumed last year. That alone probably wouldn't be a driver of significant price increases in 2023. By "significant" I mean commodity price increases large and durable enough to reverse consumer inflation trends in the United States and in Europe.

However, I think China's reopening also will create demand outside of China. In Japan, Korea, Thailand, Australia, but even farther afield—so Europe, Canada, the United States—all of these places are likely to see an influx of demand from tourists, from folks visiting their loved ones that they haven't seen in years.

I think that travel will buoy domestic demand in these countries, and it also will probably improve the current-account positions in a number of these places. Japan and Thailand are most notable here, but probably Europe to a lesser extent, maybe even Canada. That improvement could be the impetus for further weakening of the dollar vis-à-vis these major currencies.

To your point on inflation, what we may end up seeing is stronger underlying demand that shows up in fits and starts and results in still-moderating but more volatile domestic inflation in places such as the United States and Europe.

Of course, in real time, it's difficult to disaggregate which part of that demand is coming from domestic residents consuming more because their income is stronger, and which part is coming from tourism. That dynamic will probably complicate monetary policy for the central banks. So that's how we see China's reopening impacting growth around the world—through changes in domestic demand in some of these countries, and through still-decelerating but more volatile inflation.

Hugo: The strength of the dollar is one of the dominant themes of the past 10 years, so what you're saying about a weaker dollar is reversing one of the supercycle themes that investors have come to rely upon. You said the point of forecasting is to predict big changes such as this one. What's your model for how to think about investing around a weaker dollar? Is there another period of history that we can look to as an analogue?

Olga: That's a really good question, and we have spent a lot of time thinking about this one. I rarely answer your questions directly, but this time I will, so I may score points where I can. The period that we look to be entering in the 2020s is most reminiscent of the last what I would call "normal" expansion that we experienced, which was 2003 to 2007. A lot of the changes that we're highlighting today are exactly the same macroeconomic setup as we experienced then.

Back then, the dollar was moderating. It was losing value relative to the euro and the Japanese yen. At the same time, on the policy side, interest rates in the United States were moving up. The fed funds rate increased from 1% to 5.25%, while the U.S. 10-year note stayed in a relatively narrow band, somewhere in the 3.5% to 4% range.

That period of economic expansion was extremely fruitful for equities. We saw equities markets returning around 15% on average during that entire time period, and virtually all of that performance was driven by earnings growth.

Obviously, the types of companies that lead the charge this decade are likely to be different. But the broad macroeconomic environment may very well end up being similar.

Hugo: It was put to me that the next bull market will begin when the following conditions are met. The first is that the darlings of the previous bull market—big tech, high growth—are derated sufficiently, such that investors no longer view them as outperformers. The second is that there's some kind of credit event caused by this steep slope of Fed tightening. The third is that the dollar breaks.

Are you forecasting that the dollar will break? If so, does that get us to the conditions for the next bull market in global equities? We've had a derating of some of the best-performing equities in the last bull market. We've seen the repricing of credit as well, caused by the yield curve changing. And then, if investors are hiding in a strong dollar, and that breaks, you kind of have the forest fire. You reset to get ready for the next bull market. Do you agree with that?

> The more the Fed raises rates from here, the greater the probability of a major credit event.

Olga: It's not a bad theory to work with. As you've just identified, we already have at least two of the three conditions, and possibly all three. In terms of a major credit event, these are devilishly difficult to forecast. Obviously, the more the Fed raises rates from here, the greater the probability of such an event. We've had a series of smaller credit events in 2022, so some of the weaker sovereigns have already defaulted and have asked for International Monetary Fund (IMF) help.

We’ve also had the crypto explosion, and there are criminal charges. The value of the bitcoin trade is roughly a third of what it was at the beginning of 2022. So we’ve had some shakeout already. None of these feels like a whale. But I don’t know if we need a credit event of the magnitude that people evoke when they talk about the 2008 global financial crisis.

The shakeout in the consumer-facing technology platforms that have been dominant in the past decade is definitely giving way to something. Now, what is that something? Are we on the cusp of another commodity supercycle? Maybe we need a lot more lithium and nickel, if we’re all to be driving electric vehicles by the end of the decade. U.S. scientists recently announced a major breakthrough in nuclear fusion, a technology that people have been excited about since the ’50s. Might that be a catalyst for growth?

COVID has exposed all sorts of vulnerabilities in the superefficient supply chains. We may see more duplication and production for the domestic markets that are closest to you. We’re starting to see companies talk about that.

And, of course, what underpins growth in virtually every sector today is semiconductor chips, and the materials and the technologies that go into making ever-better chips for the next level of computing, whether it’s quantum computing or something else.

The example that I’ve been thinking about a lot recently is 5G buildout. We all saw what kinds of business models were enabled by the improvement in connectivity from 3G to 4G, such as streaming entertainment on our phones and ride-sharing services. What are we likely to see when we finally move to 5G? Are we going to get that in healthcare? Are we going to get that in industrials?

For now, I see no obvious candidates to lead the next bull market, but it almost certainly won’t be the winners of the past decade.

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