Second Half 2023 Outlook: The Imagination for Reality

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We started 2023 with a mantra from Goethe: “Enjoy what you can, endure what you must.” After a roaring rally in equities and a much-improved showing from fixed income compared to 2022’s weakness, 2023 has been a year of far more enjoyment than enduring.

As we turn our attention to the second half of 2023 and beyond, we call upon another zinger from Goethe with his assertion that “few people have the imagination for reality.”

When we assess our expectations going into 2023, we had the imagination for a reality of a stronger U.S. economy compared to consensus estimates that were calling for an imminent recession. We expected this growth to keep upward pressure on both Fed policy tightening and interest rates. We thought this would create an environment that could be supportive for equity earnings, compared to dire forecasts for an earnings collapse, but present a headwind for equity valuations, as interest rates and tight policy kept a lid on multiple expansion, resulting in muted returns for equity indices.

Of course, 2023 has not experienced muted returns in major capitalization-weighted indices thus far, revealing where we have, instead, lacked the imagination for reality. Instead of higher yields and tighter policy being a headwind for equities, other dynamics have mattered far more. Factors such as much-improved liquidity versus 2022 (despite continued policy tightening), highly concentrated performance, a positioning chase as investors were pulled from underweight to overweight equities, and a surge in optimism and fervor around the benefits of exciting technologies, have all contributed to surging valuations. In fact, all of the S&P 500’s 2023 gains have come from valuation expansion, while earnings have been a slight detractor from price gains.

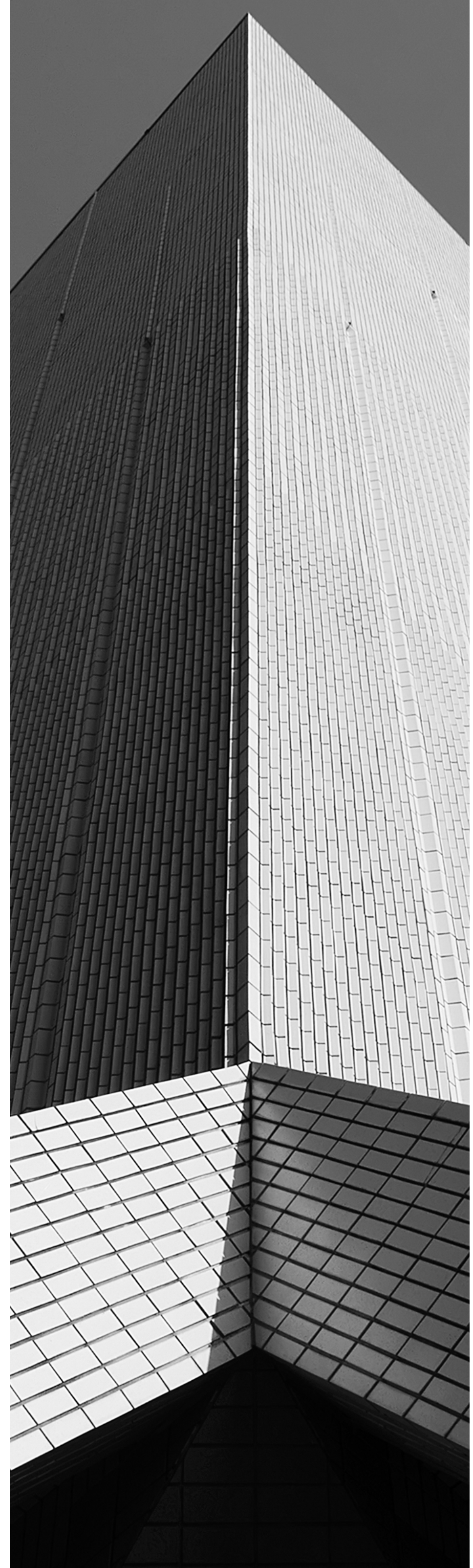
Looking to the remainder of the year, we present the attached slides and analysis as a way to help us imagine various realities. At risk of oversimplifying a complicated market and economy, we summarize the views in the attached outlook as follows:

We expect:

- A stronger, more resilient economy than consensus expects, with low risk of a recession beginning in 2023, but watching closely for yet-to-be-seen cracks into 2024
- Tighter-for-longer Federal Reserve policy than what the bond market has currently priced into rates
- Upward pressure on, or at least a floor under, interest rates as long as the U.S. economy remains resilient, with full-year fixed income returns continuing to be driven more by yield than price appreciation until yields begin to fall more substantially

“Few people have the imagination for reality.”

– Johann Wolfgang von Goethe



- Equity returns in 2H23 are lower than 1H23 after valuations have already re-rated to the high-end of prior ranges, positioning has normalized, and liquidity fades as a headwind, while upside to earnings estimates for 2023 is possible given better economic growth and near-term technical price momentum remains strong

- Continued, yet selective, opportunities within diverse alternative asset classes, as the disruptions from 2022 continue to weigh on and create opportunities in these asset classes

There is always potential for surprise, both to the upside and the downside, which is why we encourage investors to employ a long-term perspective, mostly in times of great uncertainty. Controlling what you can in terms of maintaining a long-term strategic asset allocation and wealth strategy is critical.

Download the chart deck.

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