Q2 2023 OUTLOOK SUMMARY

PLAYING THE LONG GAME IN A RISK-OFF WORLD

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The first few months of 2023 made one thing very clear: Market volatility fueled by a wavering outlook for inflation was not ready to quietly fade into the background. The evolution of inflation, key decisions in monetary policy and lingering recession fears continue to reshape the investment landscape with a new regime of higher interest rates seemingly taking hold. Meanwhile, Silicon Valley Bank's collapse, followed by the hurried sale of Credit Suisse, added a new layer of uncertainty to financial markets. As the bank crisis showed, investors must also be prepared for risks that may emerge as financial conditions tighten.

With the path for inflation, rates and the global economy still in doubt, it is perhaps more important than ever for investors to maintain a long-term vision for their portfolio and capture new opportunities as they reveal themselves. PGIM brings the following perspectives from its affiliates to examine both opportunities and challenges present across asset classes.

PGIM Fixed Income

On the face of it, the first quarter brought bad news. A banking crisis joined an economic backdrop already at risk from central bank rate hikes. Economies will now have to cope with the frictions and the long tail of the crisis. The culmination of risks, including intensifying global competition and the dire consequences of the U.S. debt ceiling showdown, could bring a U.S. recession—and its global knock-on effects—even closer. But there are periods when negative developments can be market positive. The cumulative impact of higher rates and the mounting risks from Q1 are negatives for growth. However, once yields reach elevated levels—thanks to last year's bear market—and the economy begins to slow, bonds can be quite productive. Hence, the game is still on for the bond market. An array of dispersion throughout sectors—from property types to emerging market spread levels—enhances the potential for alpha generation through sector rotation, issue selection, term structure positioning, and foreign exchange exposure.

Jennison Associates

The better-than-anticipated start to 2023 does not alter the expectation of moderating US economic activity over the balance of the year. Tighter credit conditions are a likely outcome of recent events in the banking sector. Availability of credit is likely to be constrained, as banks focus on deposit composition and resiliency, against a backdrop of rising costs and the lagging effect of liability repricing that crimps profits. Companies are taking more aggressive steps on cost rationalization, expecting a more challenging environment ahead. Equity markets' positive start to the year reflects a resilient consumer, moderating inflation, corporate profit resiliency, improved CEO confidence, and more favorable valuation levels following last year's declines. Growth companies began the year with greater valuation compression, and we believe they present a more resilient outlook in the face of a slowing economy. Corporate results from the recently concluded fourth-quarter reporting season revealed positive trends with respect to costs and inventories, and many companies have put the worst of the pandemic's comparisons behind them. Expectations for secular growth companies now reflect renewed stability in revenue growth and profits following last year's adjustments.

PGIM Quantitative Solutions

Global markets were off to the races in January with broad-based gains across equities, sovereign bonds, and credit. However, uncertainty around inflation and Fed policy led to a tug-of-war between risk-on and risk-off in markets, even before the banking-sector blowups. Long-term bond yields fell precipitously as rising risk aversion gripped markets. US equity market valuations still do not fully price in possible downside scenarios, despite visible recession signals. With an increased possibility of a tail-risk situation, we expect equity valuations to adjust to this new reality. Non-US equities have a relatively better risk-reward tradeoff. While Europe and Japan have more favorable starting points with forward PE ratios comfortably below historical median levels, these markets are also more cyclically oriented and sensitive to downside economic risks. Market valuations in China are attractive, and the country's economic reopening is expected to pick up steam on the back of easing monetary policy and measures to support growth. As a cyclical asset, commodities will likely struggle in the face of a broad economic slowdown. While China's reopening is a positive, rising recession worries are contributing to near-term volatility. However, we remain positive on this space in the medium to long term.

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