GLOBAL OUTLOOKS 2023

Focus on quality for success in equities

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Investors should not expect everything to go 'back to normal' in 2023, says Melda Mergen. Higher inflation and a weaker economic environment will mean not all companies will thrive

As the economy reopened after the Covid-19 pandemic, we saw a lot of one-off drivers of inflation, but longer-lasting drivers have also been unleashed. So, we are now seeing changes in supply chains – companies reshoring and building out new networks – and geopolitics, and these don't resolve quickly. I do expect inflation to fall, but not back to pre-pandemic levels. When a dislocation like this happens you never go back to where you started, and where we end up is one of the key questions for 2023.

Issued December 2022

Inflation generally means equity valuations come down, and we saw that through 2022, but on a broad market basis. I think that we will see greater dispersion in terms of valuation in 2023, with longer duration equity – companies with growth expectations farther out in the future – suffering more. Investors will have to be more careful about what they are willing to pay for future earnings, and demands for profitability will come sooner. All of this will mean that companies that aren't able to deliver earnings are more likely to see the market take down their valuation.

Cash on hand will matter

Many investors think of valuation in terms of price-to-earnings (P/E) multiples, and although that metric is useful it is not the only measure of a company's value. I think free cash flow will be more important as a metric because it will be a good indicator of how resilient a company may be in a weaker economic environment and while inflation is running higher. Cash on hand can also help deliver stock buybacks, which can support a company's stock price. It will be a lot more expensive to fund buybacks through debt so free cashflow and dividend growth (rather than the absolute level of yield) are both metrics that may indicate a higher quality company.

Relative opportunities, resilient companies

While economic growth is slowing, at this point it doesn't look like a recession in the US will be very deep. In contrast, economies in Europe are under significant stress and a deeper

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recession there seems likely. In emerging markets, we have seen economies under stress from China's zero-Covid policies, the strong US dollar and geopolitics.

In thinking about global opportunities, at a high level the US is more attractive than other regions. I also think that small caps may offer greater opportunity than large caps, especially since larger companies tend to have greater non-US revenue exposure, with around 35% of revenue outside the US. I also still think that a tilt towards value over growth makes sense. There are certain value areas – industrials or energy, for example – that will still be benefiting in 2023. That said, growth is becoming more interesting. Many growth companies underperformed in 2022. However, we know their business models are not broken, we know they still have competitive advantage. But because interest rates rose in 2022, the valuation of these companies came down, there was a significant rerating. If you believe that is now done, then I think growth will be very interesting too.

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However, either way you will need to go deeper than big picture observations to succeed in 2023, meaning an active, company-by-company approach. Passive indexes, especially in international markets, can have embedded concentrations that can hurt portfolio performance. To succeed in 2023 you will really need to distinguish between companies that are more resilient and those that aren't.

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