HARTFORDFUNDS
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It's All About Valuations

As a degree of normality returns to markets, a focus on valuations must return, too.

Having just lived through a once-in-generation crisis in the form of the COVID-19 pandemic, we're now seeing the status quo of the past 30 years turned on its head. After decades of relative peace and falling inflation, we find ourselves confronted by increased geopolitical tension and rising inflation.

As investors, however, we're seeing a return to some semblance of normality. I don't mean that this environment is easy by any means, but for the first time in a long time we have positive nominal interest rates on holding cash. This changes the investment dynamic considerably compared to a couple of years ago, when we were forced to buy ever-more expensive assets in a world of endless liquidity in seeking to generate return.

From Denial to Acceptance

In recent months, the mindsets of investors have moved from denial to acceptance in terms of their expectations of central-bank hikes. Market expectations are now reasonable. This is a big change compared to last summer.

Diverging central-bank policies, driven by differing levels of inflation, exposure to the energy crisis, and the pandemic, also create opportunities within asset classes.

In the last decade, with quantitative easing and rates pretty much pinned down at zero across the world, there was very little differentiation in monetary policy. This made it hard to take investment positions that favored one country over another.

Recoveries Come at Different Speeds

Now, we still probably have to work our way through a recession in 2023. Looking back at how we came out of the 2001 recession, we saw economies recovering at different speeds. This made it interesting from an investment perspective and I certainly think this could be a great opportunity over the next couple of years.

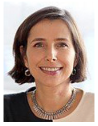
Already, it's worth noting that emerging markets were far quicker to deal with inflation last year, so they're getting very near to the end of their tightening cycle. They've already taken a great deal of pain by pre-emptively raising rates, and we now see some value in emerging-market assets.

Inflation Will Be Key to Performance in 2023

Provided inflation does come down, we could start to see a more benign environment for markets. But if inflation persists, rates might then have to go even higher, and markets would have to reassess valuations once again.

However, compared to the volatility of 2022, we expect interest rates, and therefore fixed income, to be more stable in 2023, allowing investors to take advantage of the yields on offer. Indeed, the appeal of bonds has shifted from diversification benefits to yields.

Insight from sub-adviser Schroders Investment Management



Johanna Kyrklund
Group CIO and
Co-Head of Investment

Key Points

- For the first time in a long time, we're seeing a return to some semblance of normality. Market expectations are now reasonable. This is a big change.
- After the 2001 recession, economies recovered at different speeds, creating opportunities. As we work through a probable recession in 2023, we've already seen some value in emerging-market assets.
- The appeal of fixed income has shifted from diversification benefits to yields. While equity valuations don't look quite as attractive, markets outside the US look very cheap.

Earnings Expectations Need to Come Down

Turning to equities, we don't think valuations are as attractive as bonds, and we need earnings expectations to come down further given recessionary risks.

What could be the triggers for a stronger recovery in equities? Any evidence of a weaker labor market in the US would allow the Federal Reserve to back off raising rates, which would allow bond yields to adjust downward and equities to re-rate.

There could also be more potential opportunities within equities. After years of unrelenting outperformance by the US, driven by the strength of the technology sector, markets outside the US now look very cheap.

But, as we've already touched on, investors will need to be more discerning and selective, both on countries and companies in this new environment. There will be an increased divergence between the winners and losers in both fixed-income and equity markets.

We should also remember that, historically, some of the best opportunities for equities occur in the midst of recessions. Markets always move ahead of economic news. So, in 2023, investors need to focus on valuations, not newspaper headlines.

> Given the recessionary risks, we need earnings expectations to come down further.

For more information on the outlook for equities and fixed income in 2023, talk to your financial professional.