RPIA

The Paradigm Shift and the Case for Credit

Key Takeaways

- During 2022, we witnessed a paradigm shift in markets. Investors may want to think twice before "buying the dip" in equities due to the new environment and valuation levels.
- Given the outlook, we believe investors should consider tactically substituting some equity risk with credit risk.
- Doing this should make one's portfolio more resilient in an uncertain environment for risk assets. It also enables investors to take advantage of the more attractive income/yield offered by credit compared to equities.

Recession Expectations

Today, many market participants are anticipating a short and shallow recession, followed by a reduction in interest rates in a few quarters' time. This is captured by the inverted shape of the yield curve whereby short-term interest rates are a lot higher than longer-term rates. After a decade-long bull market in stocks, investors also seem to be banking on a near-term rebound in the equity market. The sizeable equity price rally witnessed from early October to early December 2022 suggests that the "buy the dip" mentality is alive and well. Historically, an equity price surge has indeed often occurred in the first two years following a recession's end (the exception being 2001 - 2003). However, we believe more caution is warranted at this juncture, and investors are better served by taking a more conservative stance.

The Paradigm Shift

We believe there was a paradigm shift in 2022, marking a decisive break with the previous decade. More specifically, in view of the extraordinary course of monetary policy experienced over the past several years, investors really should be asking whether the market is correct in hoping for the traditional recession playbook. Given high global debt levels, deglobalization, decarbonization, demographics, geopolitics, and the likelihood of more frequent supply shocks, there are strong reasons to suggest that the world has experienced a major regime change. At the very least, it seems clear that the long period of low inflation, suppressed volatility, and easy financial conditions is over.

Elevated volatility and macro uncertainty should raise real concern regarding the likely future performance of equity-tilted portfolios. Looking back, there is no doubt that monetary and liquidity conditions have been incredibly favourable for equity investors in both public and private markets and especially for those strategies that buy assets using leverage. But while central banks are likely to moderate the pace of interest rate increases, we do not expect to see a return to stimulative policies. The probability of rates being 'higher for longer' reflects a concern that the worst outcome for the US economy would likely come from allowing inflationary expectations to become entrenched. Learning the lesson from Paul Volcker in the 1980s, central bankers have signaled their determination to make sure they decisively defeat inflation before loosening the reins on policy.

Understanding Valuations

Although equity markets have corrected meaningfully, especially in the US, valuations are still far from compelling by historical standards. Equities have repriced lower in response to higher interest rates.

However, have equity valuations fallen enough given the outlook for a recession and economic slowdown?

In uncertain times, it is important to pay attention to valuations as an anchor. Studies that look at valuations today versus long-term relationships suggest that equities may still be trading above fair value. An example of this kind of analysis is shown below, taken from US consulting firm Research Affiliates. They find that, even after the market correction of 2022, many equity markets are trading 10-20% above long-term fair value levels.

Analysis Suggests That Many Equity Markets Are Still Significantly Overvalued at Today's Multiples

Equity Market	Index	Current P/E multiple	Fair Value P/E multiple	Estimated Overvaluation (%)
All country	MSCI ACWI	22.2x	19.7x	12.6%
Global Developed	MSCI World	23.9x	20.8x	14.9%
Emerging Markets	MSCI EM	13.4x	14.4x	-6.7%
US Large	S&P 500	27.8x	22.8x	21.7%
Canada	MSCI Canada	19.4x	18.8x	2.9%

MSCI All Country World Index, MSCI World Index, MSCI Emerging Markets Index, S&P 500 Index, MSCI Canada Index.
Research Affiliates estimate valuations and forecast expected returns for equity indices using a model which sums estimated dividend yield, real EPS growth forecast and a valuation forecast. Estimated dividend yield is extrapolated from trailing dividend per share. Real EPS growth forecast is estimated from historical trends. The valuation forecast component is based on mean-reversion in the cyclically-adjusted earnings yield. More information can be found here: https://www.researchaffiliates.com/content/dam/ra/documents/asset-allocation/aa-methodology-822.pdf
Source: Research Affiliates Asset Allocation Interactive, December 2022

This overvaluation may stem from overly optimistic expectations around corporate profits. While equity prices have factored in higher interest rates, we do not believe investors have adequately factored in the profits/earnings impact of a slower economy. This is particularly due to the evolving global economic downturn and the plethora of cyclical and structural headwinds (labour market tightness, inflation, increased cost of financing, US dollar strength, deglobalization and onshoring, rising regulatory burdens, etc.). Aggregate corporate profit margins are currently well above the long-term average (approx. two standard deviations). Surely any noticeable reversion toward the mean in profits would precipitate another leg-down for equities, and history suggests that the third down leg is often the most severe.

Equity Risk vs. Credit Risk

With these considerations in mind, we believe investors should consider substituting some equity risk with credit risk. As discussed above, we believe there has been a regime shift in markets and that the coming period will be characterized by more volatility and macroeconomic uncertainty. Looking at valuations, we also believe there may be more weakness in store for the equity markets. With this in mind, we think allocators with the flexibility to adjust portfolio weights may want to tactically substitute some equity risk for credit risk.

We see two benefits investors can obtain from doing this:

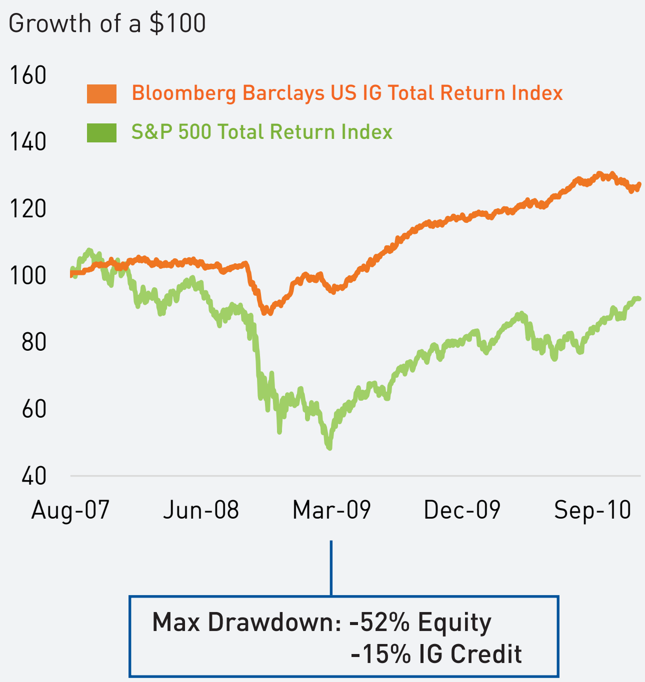
1. **Investors would benefit from having a portfolio with more resilience/downside protection given the uncertain market outlook.**

2. **It enables investors to take advantage of a significant dislocation between the relative attractiveness of bond yields versus equity earnings yields.**

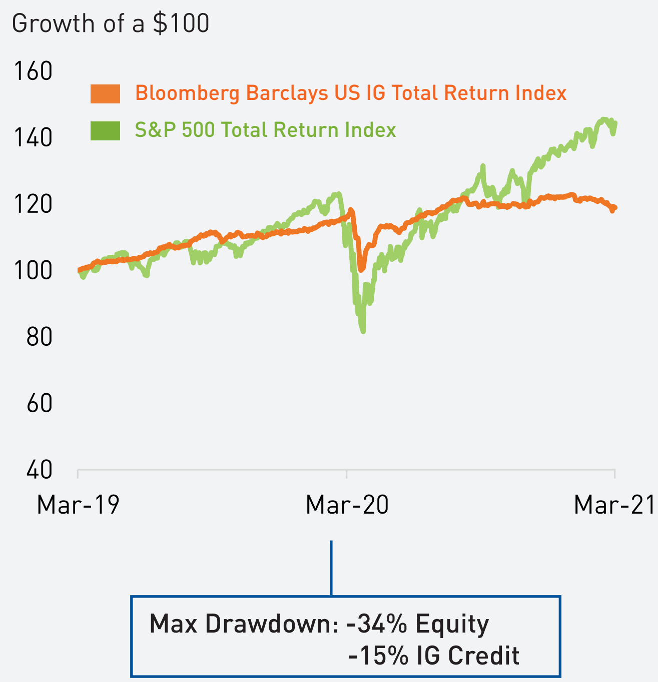
Regarding the first benefit, consider that - compared to equity investments - investing in fixed income provides more senior positioning in a company's capital structure, more covenant protections, and consistent income. These characteristics help explain why fixed income tends to be more resilient in periods of stress and provides downside protection for a balanced portfolio. Moreover, fixed income tends to bounce back quicker than equities when markets stabilize. The chart on the following page illustrates two recent market corrections and demonstrates the differences in drawdown between equity and fixed income indices.

During Periods of Market Stress, Investment Grade Credit Allocations Have Been Much More Resilient Than Equity Investments

Global Financial Crisis (2008)



COVID-19 Crisis (2020)

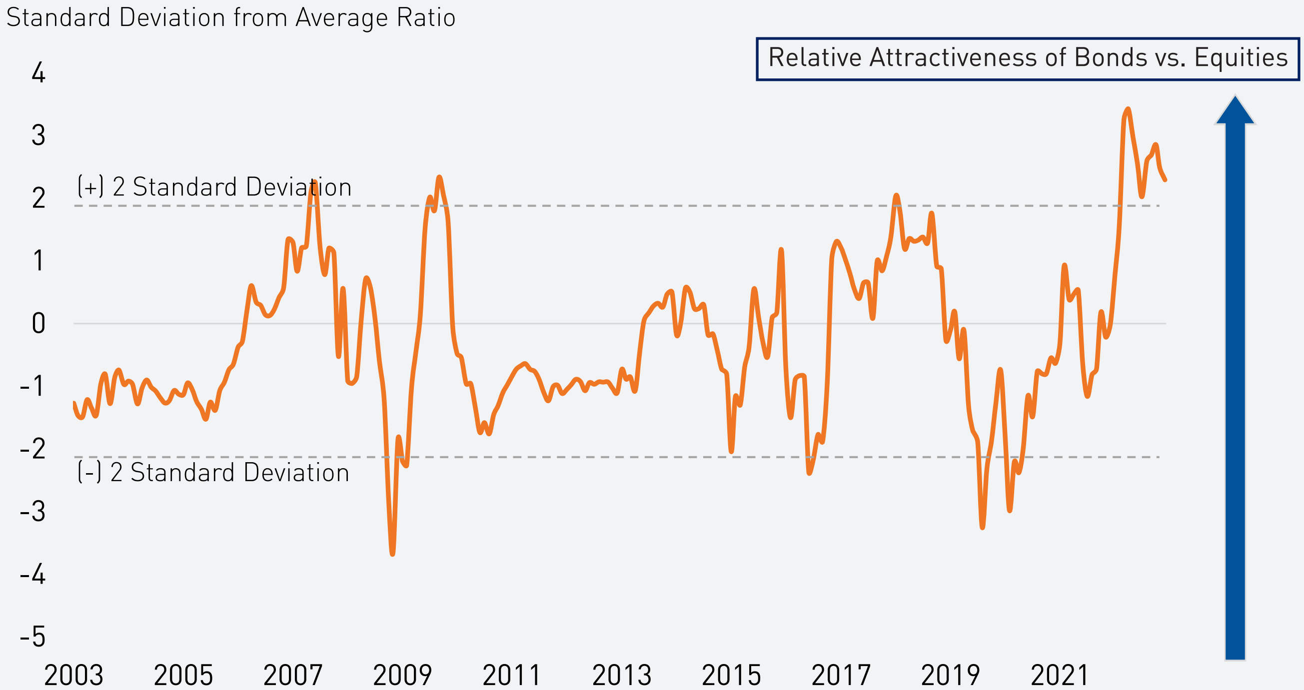


Source: Bloomberg.
Max drawdown for GFC calculated from May 19 2008 to Mar 3 2009 for S&P 500 and from Sep 9 2008 to Oct 31 2008 for US IG.
Max drawdown for COVID Crisis calculated from Feb 19 2020 to Mar 23 2020 for S&P 500 and from Mar 6 2020 to Mar 20 2020 for US IG.

This additional resilience does not have to come with sacrificing income or return. Relative to the equity earnings yield, we believe the fixed income coupon yield is very attractive by historical standards. Valuations of essentially all public asset classes dropped materially in 2022. However, we believe fixed income and credit have repriced to very attractive levels, whereas equities may still have downside risk. One way of thinking about this is to consider the ratio of bond yields to equity earnings yields to assess the relative cheapness of the two asset classes. The relationship is currently at a multi-decade high, favoring bonds over equity. At present, the relationship is 2-3 standard deviations away from average in favor of bonds.

This is a significant divergence – although it is consistent with other periods in history heading into a recession. Fixed income tends to reprice very quickly when short term interest rates rise, whereas it can take longer for equity investments to reprice as investors digest the real economy impact of higher rates over a longer timeframe. We believe that is what has occurred over the last couple of quarters of 2022.

The Ratio of Bond Yields to Equity Earnings Yields Is 2–3 Standard Deviations Away From the Long-Term Average - in Favour of Owning Bonds



Date as of 12/31/2022. Source: Absolute Strategy Research. Global Bond Yield: Yield-to-Worst of the Bloomberg Global-Aggregate Total Return Index Value Unhedged USD; Equity Earnings Yield: Earnings yield of the MSCI Index. Z-Score is calculated as the observed value at any certain time point minus average of the dataset, divided by the dataset's 3-year standard deviation.

Conclusion

We think 2022 was a pivotal year, marking the shift into a new paradigm – one that will be exemplified by tighter monetary policy, less liquidity, and more volatility. We are still early in this new regime and much is unknown about the future path. We believe investors hoping that heavily equity-focused portfolios will be optimal will be disappointed. We believe investors can benefit from switching a portion of their equity risk to credit risk at the present time to make their portfolio more resilient to market weakness and take advantage of the attractiveness of fixed income yields.

Please feel free to contact the Institutional Team if you would like to discuss this topic further.

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