



Julius Bär

# INVESTMENT GUIDE

Market Outlook 2023

Marketing Material

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Please find important legal information at the end of this document.

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Julius Bär

# Editorial

Dear reader,

2022 turned out to be a perfect storm, as a major war in Europe, a global energy crisis, and record-breaking inflation were accompanied by a synchronised, ruthless monetary-policy tightening campaign by global central banks, leading to the worst bond market sell-off in centuries and an equity bear market. On top of all this, China suffered a marked slowdown, driven by its zero-tolerance policy on Covid-19 and continued issues related to its real estate sector. Where does that leave us as we enter 2023?

There is no doubt that geopolitical tensions are likely to continue, following what we call the ‘end of the peace dividend’. When it comes to the macroeconomic outlook, we expect 2023 to be about recent trends cooling down on many levels. Both growth and inflation rates are likely to slow, especially as the year progresses.

Against this backdrop, investors should look to capture the attractive yields offered in segments such as high-investment-grade bonds and quality stocks. And if early economic indicators start to bottom, then cyclical opportunities should be on your radar screens too.

In this Investment Guide, we aim to help you navigate through the investment environment that we expect to unfold in 2023. We hope that the year ahead will be free of disruptive surprises. If it is not, then rest assured that we will be here to help you to adjust your investment approach. In the meantime, we wish you a successful year and thank you for your continued trust in Julius Baer.

Yours faithfully,



**Yves Bonzon**  
Group Chief Investment Officer  
Member of the Executive Board



**Christian Gattiker**  
Head of Research

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# A brief review

2022 was an annus horribilis for the financial markets. The traditional 60% equities/40% bonds portfolio suffered unusually, returning between -20% and -15%. This was exceptional, given that since 1901 it has delivered between 0% and 20% on average. As for asset classes, it did not seem to matter which ones you invested in: all but a few ended the year in negative territory. Amid the geopolitical and weather events, oil & gas stocks provided some relief to those invested, and floating-rate notes offered some compensation to bond investors as interest rates rose globally.

# Market review

2022 was a year in which almost all assets lost value in sync – a relatively rare occurrence. On top of this, the year was characterised by a second peculiarity – the economic mix that financial markets faced. After the valuation reset, we expect a further cooling down in growth and inflation for 2023.

## Equity regions

	2018	2019	2020	2021	2022	5-year annualised
Switzerland	-8.03%	29.98%	1.07%	19.51%	-17.50%	4.25%
Eurozone	-10.57%	26.05%	-3.32%	21.54%	-9.94%	4.30%
USA	-5.04%	30.88%	19.70%	25.75%	-20.31%	8.56%
Japan	-15.15%	18.48%	10.23%	12.93%	-6.45%	2.89%
UK	-8.82%	16.37%	-13.93%	15.13%	5.33%	3.47%
China	-19.45%	24.34%	29.49%	-19.30%	-21.43%	-4.54%
Emerging markets ex. China	-12.43%	16.23%	12.55%	7.87%	-19.65%	0.37%

### The best

Just one of the main equity regions ended 2022 in the green – the UK. All this despite the effects of Brexit, a total of three prime ministers, and a period of chaotic governing and economic ructions. It was, however, the UK equity market's value tilt, with above-average exposure to commodity-related stocks, that allowed it to outperform.

### The worst

The US and emerging markets including China performed worst, but equity markets globally came under immense pressure, driven by a sharp tightening in liquidity conditions due to sky-high inflation rates and geopolitical jitters. The sell-off in developed markets can be entirely attributed to a decline in valuations, while zero-Covid measures meant uncertainty for Chinese stocks.



## Equity styles

	2018	2019	2020	2021	2022	5-year annualised
Quality	-5.50%	36.08%	22.20%	23.24%	-22.16%	8.96%
Value	-10.78%	21.75%	-1.16%	18.42%	-6.62%	4.12%
Growth	-6.74%	33.68%	33.83%	19.33%	-29.56%	7.43%
Large cap	-7.75%	27.73%	15.94%	20.04%	-18.31%	6.57%
Small cap	-13.86%	26.18%	15.96%	12.09%	-19.07%	3.46%
Cyclicals	-9.83%	31.54%	19.30%	25.80%	-22.40%	6.90%
Defensives	-4.94%	21.69%	1.60%	21.70%	4.20%	8.60%
High dividend	-7.56%	23.15%	-0.03%	12.07%	-4.76%	4.66%

### The best

Defensive sectors were the outperformers in 2022, benefiting from the rotation out of cyclical stocks amid the challenging macroeconomic backdrop. While defensive sectors might continue to hold up well in early 2023, we expect them to underperform into the recovery in the second half of the year.

### The worst

Growth stocks sold off nearly 30% in 2022. This comes as little surprise in a year when the only direction of interest rates was up and therefore not good for companies planning quick expansions and, in many cases, only promising sustainable profits far into the future.

## Equity sectors

	2018	2019	2020	2021	2022	5-year annualised
Information technology	-2.60%	47.55%	43.77%	28.21%	-31.26%	13.17%
Materials	-16.92%	23.35%	19.93%	12.19%	-9.97%	4.99%
Oil & gas	-15.84%	11.45%	-31.46%	37.71%	43.77%	5.63%
Industrials	-14.54%	27.77%	11.68%	14.10%	-12.79%	4.29%
Communications	-10.02%	27.39%	22.98%	13.02%	-37.17%	0.33%
Healthcare	2.52%	23.24%	13.52%	15.52%	-4.54%	10.19%
Financials	-16.97%	25.51%	-2.84%	24.80%	-10.62%	3.06%
Consumer cyclical	-5.51%	26.57%	36.62%	15.67%	-34.61%	5.13%
Consumer defensive	-10.10%	22.80%	7.79%	9.85%	-6.13%	4.78%
Real estate	-6.36%	22.96%	-4.99%	24.11%	-24.50%	1.06%
Utilities	1.97%	22.53%	4.76%	6.09%	-4.11%	6.50%

### The best

As the Ukraine war became more entrenched and fears grew of a looming energy crisis, it is no surprise that the stand-out sector of 2022 was oil and gas. Not only was the sector alone in closing the year in the green, but it did so in spectacular fashion moving up by more than 40%.

### The worst

Communications, consumer cyclicals, and IT had a very bad year. The sharp increase in real interest rates put pressure on high valuations and saw investors grow concerned about the potential for future earnings. Nevertheless, despite IT being one of the worst performers of 2022, it has still delivered the best 5-year annualised return.

## Fixed Income

### Developed markets

	2018	2019	2020	2021	2022	5-year annualised
US government bonds	0.86%	6.86%	8.00%	-2.32%	-11.65%	-0.03%
US TIPS	-1.26%	8.43%	10.99%	5.96%	-11.38%	2.16%
High investment grade	-3.54%	6.33%	11.89%	-7.17%	-22.89%	-4.13%
Low investment grade	-3.90%	12.52%	11.56%	-4.42%	-17.92%	-1.24%
High yield	-4.06%	12.56%	6.91%	0.36%	-12.51%	0.35%
USD floating-rate notes	1.63%	4.28%	1.38%	0.52%	1.33%	1.82%

### Emerging markets

	2018	2019	2020	2021	2022	5-year annualised
EM hard currency	-3.02%	12.13%	7.02%	-2.48%	-16.24%	-1.09%
EM local currency	-3.40%	9.47%	5.29%	-2.53%	-8.23%	0.07%

#### The best

Floating-rate notes were the only place to hide given the shield that they provided against the rise in interest rates triggered by the aggressive tightening cycle embarked upon by central banks. It is therefore no surprise that they are the only segment to end 2022 in the green.

#### The worst

Fixed income markets across the board had a shocking year. Longer-duration bonds suffered the most which meant higher quality investment grade took the biggest hit given their longer average maturity. Rate hikes, higher bond yields, and wider credit spreads caused a meltdown, particularly in the second and third quarters.

## Commodities

	2018	2019	2020	2021	2022	5-year annualised
Brent crude oil	-19.55%	22.68%	-21.52%	43.61%	10.45%	5.14%
US natural gas	-0.44%	-25.54%	15.99%	49.43%	19.97%	8.66%
Gold	-2.14%	18.87%	24.42%	-5.74%	-0.13%	6.88%
Silver	-9.36%	15.32%	47.38%	-15.61%	2.95%	6.99%
Platinum	-14.80%	22.05%	10.71%	-14.02%	11.33%	2.82%
Aluminium	-19.28%	-1.84%	10.61%	34.93%	-16.18%	0.80%
Copper	-17.43%	3.32%	25.97%	25.65%	-14.10%	3.01%
Iron ore	-0.22%	28.70%	70.26%	-27.81%	-1.08%	9.31%

#### The best

Natural gas was the top performer of 2022. Unlike in Europe, where the price was driven higher due to geopolitical concerns, US prices mainly rallied because of the hot summer and strong economy pushing up power and thus gas demand. Despite the rally, performance peaked in the summer and subsequently declined by 50%.

#### The worst

Aluminium initially rallied to new record highs on fears that the war in Ukraine and the sanctions on Russia would curb supplies. As this did not happen, market participants started to worry more about China's struggling property market, pushing down prices for the year.

**Source:** Bloomberg Finance L.P., Julius Baer Investment Writing

Note: Please see the 'Further Information' section of this Guide for more details on the indices used. Annual performance numbers are in USD, except for equity regions that are calculated in local currency. EM = emerging markets; TIPS = Treasury inflation-protected securities. Past performance is not a reliable indicator of future results. Returns reflect all ongoing charges excluding transaction fees. All investments have inherent risks, and investors may not recover their initial investment.

# Scoring our calls

In this section, we show how our key investment ideas for year-end 2022 played out until 31 December 2022.

Topic	Investment idea	Return*
The big picture	Fixed income – moderate credit risk	-0.29%
	Barbell approach to stocks – value stocks	-4.83%
	Barbell approach to stocks – growth stocks	-6.20%
	Stocks with a defensive tilt – US stocks	-2.65%
	Stocks with a defensive tilt – high-dividend US/Asia	3.25%
	Stocks with a defensive tilt – healthcare stocks	7.81%
The future is green	Clean Energy	0.01%
	Future Mobility	0.01%
	Environment	0.27%
Ready to rumble	Stocks set to recover – information technology	-11.42%
	Stocks set to recover – digital health	7.99%
Investing matters	Fixed income – quality high yield	2.70%
	Fixed income – deeply subordinated bank debt	1.13%
	Stocks to own	-3.04%
	Pets – an unbroken trend	-6.73%
	Macro hedge fund strategies	-0.24%

**Source:** Julius Baer Investment Writing

Notes: \*Return numbers are for the period between 1 September 2022 and 31 December 2022. The performance of our calls was evaluated on the basis of the performance of a representative benchmark index that we consider the best fit to our call. Certain calls may not be reflected due to the lack of an appropriate benchmark. More information on these benchmark indices is shown in the 'Further Information' section of this Investment Guide. Past performance is not a reliable indicator of future results. Returns reflect all ongoing charges excluding transaction fees. All investments have inherent risks, and investors may not recover their initial investment.

A low-angle, upward-looking photograph of modern buildings. On the left is a light-colored concrete building with vertical window slits. On the right is a red brick building with large glass windows. The sky is blue with scattered white clouds. A dark blue rectangular box is overlaid in the center, containing white text.

# The economic picture

2023 will likely be about the cooling down of recent trends, with both growth and inflation rates expected to slow as monetary policy normalisation takes its toll and pandemic-related constraints ease. Nonetheless, strong employment trends and divergent regional dynamics should prevent a global recession. While Europe's energy supply risks have eased meaningfully, such concerns may persist for some time.

In addition, our CIO examines why the FAANMG stocks fell from grace in 2022 and which equity segments might take the crown going forward.

# The great cool-down

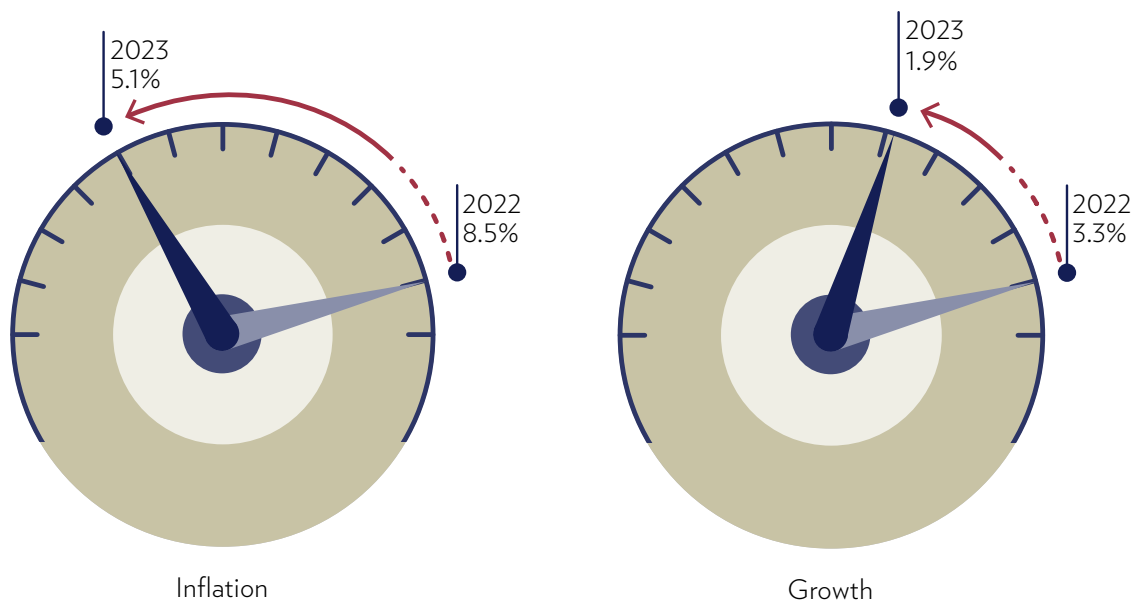
2022 was an exceptional year. Economic growth declined and inflation skyrocketed. Most assets lost value. 2023 should see a major cool-down, with growth slowing and inflation slowing even more.

## 2023 – the year of the cool-down

Predicting major shocks such as the Covid-19 pandemic, the invasion of Ukraine, and the subsequent war is one thing. Drawing the right conclusions ahead of correctly predicted events is yet another. This is the key lesson in humility for investors after the most recent crises. Looking ahead, and in all modesty, we can only state that, barring any further 'once-in-a-generation' shocks hitting the system now, inflation pressure should decline markedly in the first half of 2023 and then soften further.

There is no doubt that global growth will slow in 2023, most likely to below 2% from more than 3% in 2022, but this is still in positive territory and therefore does not signal a global recession. Although there are plenty of concerns about a recession materialising, we do not expect one in the year ahead. We see strong employment trends in many industrialised countries, which should keep their economies afloat, and regional dynamics are likely to remain very divergent. This means that, for example, a recovery in Asia spurred by tailwinds from China's reopening would be supportive of European growth prospects and also compensate for a softening of growth in the US, thus reducing the odds of a globally synchronised recession.

## Inflation and growth cooling down in 2023



**Source:** Julius Baer Investment & Wealth Management Solutions  
 Note: 2023 figures reflect the Julius Baer Economic Research expectations.

In line with the usual time lag between inflation rates and overall economic activity, we expect high global inflation rates to start coming down in 2023, easing notably in the first half of the year and then softening at a slower pace throughout the remainder of the year. This will be achieved by commodity prices cooling down, supply-chain bottlenecks easing, and a normalisation of the pent-up demand that we witnessed after the pandemic. Ultimately, global inflation should cool down from more than 8% in 2022 to 5% in 2023.

In terms of monetary policy, central-bank tightening should slow down considerably in the first half of 2023, and there is even a chance of rate cuts in the US in the second half of the year.

These factors combined suggest that investors now have the opportunity to start locking in attractive yields while looking for assets that should benefit from a recovery as the year progresses and into 2024.

#### Likely impact on the US dollar

We have just witnessed one of the longest and strongest bull markets for the US dollar since it became the global reserve currency after World War II. With the interest-rate tailwinds starting to ease, the strength of the dollar seems to have peaked and it may well weaken from here.

On the flip side, the weakness of some emerging market currencies versus the US dollar already started to dissipate in the second half of 2022, making some of the commodity-backed emerging market currencies look more attractive to risk-tolerant investors.

#### One of the longest US dollar bull markets is running out of steam



**Source:** Bloomberg Finance L.P., Julius Baer Economic Research

Note: Past performance and performance forecasts are not reliable indicators of future results. The return may increase or decrease as a result of currency fluctuations.

## A word or two on the energy situation



European energy markets remain nervous, but supply risks are minimal, which means that energy prices should ease further, and, as a result, Europe should see a pronounced softening of energy-related economic headwinds.

The globally available pool of natural gas is sufficient for Europe to fully compensate for Russia's supply cuts, not only because of Asia's pivot to coal, nuclear, and renewables, but also owing to China's economic stagnation.

We believe that the energy markets should offer further inflation relief, as opposed to inflation pain, since it is becoming increasingly clear that the drivers at play are cyclical rather than structural in nature.

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Special

# FAANMGs at a crossroads

On top of defining the prevailing macroeconomic trends, our yearly Secular Outlook seeks to identify the market-leading themes of the unfolding decade. If historical evidence is anything to go by, the winners of the past decade are unlikely to be the winners of the current decade.

The combined market capitalisation of the so-called FAANMGs<sup>1</sup> rose from USD 1 trillion at the start of 2013 to over USD 10 trillion by the end of 2021. At their peak, in the summer of 2020, they accounted for over 25% of the S&P 500 index. In this way, the six US technology giants established themselves as a true stand-alone asset class, and their rise was one of the defining trends of the previous decade. However, after they have been at the forefront of shareholder value creation over the past years of secular disinflation, we are starting to see a gradual shift, marking the end of the FAANMG supremacy. This raises two major questions:

**What role will the FAANMGs play going forward?**

The business models of some of the FAANMG companies are under serious pressure, which raises questions about their future viability as we enter the next phase of the information age. The FAANMGs urgently need to focus on the spiralling costs in order to maintain their relevance as building blocks in portfolios. While some members of the group are unlikely to be able to reverse their current negative profitability trend, others should succeed in transforming from secular growth engines into mature quality companies. Those that can manage this transition successfully will maintain their place in investors' portfolios.

**Who will be the new growth champions in the future?**

In our view, the new growth champions could emerge from those companies that manage to bring the digital revolution into the physical world. After the internet, this is the next step in digital disruptions. This space is quite large, from robotics and automation to supply-chain optimisation, but our preferred theme remains the disruptions in the life-science space, including digital healthcare and biotechnology.

<sup>1</sup> FAANMG: Meta Platforms (formerly Facebook), Apple, Amazon, Netflix, Microsoft, and Alphabet (formerly Google).

## Secular Outlook

The end of the FAANMG supremacy is just one of the topics that we cover in our Secular Outlook. To learn more about the key macroeconomic and capital-market trends that we believe will shape this decade, please read the latest edition of our **Secular Outlook** publication.



# BEYOND MARKETS

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# Attractive yields in fixed income

The end of financial repression means that fixed income assets across the credit-rating ladder now offer positive real yields again. We therefore think that now is a good time to remove some credit risk while extending duration risk. With regard to emerging market debt, several drivers have become more positive, allowing for a gradual return to quality emerging market bonds.

During the year, there might come a time where the risk/return balance advocates moving into the higher credit-risk brackets again. Interesting opportunities may also arise in selected BB rated bonds.

# Move up the credit-rating ladder

Following the central banks' dramatic policy changes last year, the pool of negative-yielding global debt reached zero in early January 2023. At the end of 2021, it stood at over USD 11 trillion. Clearly, there is income in fixed income again and investing in high-investment-grade debt now generates a decent return.

## High-investment-grade bonds

High-investment-grade bonds are now much more attractive following the significant repricing of bonds last year. While we do not believe that riskier segments of the bond market have become weaker, the end of financial repression means that interest rates have moved significantly higher, and consequently fixed income investors can now move up the credit-rating ladder, i.e. invest in higher-quality bonds, and still get decent returns. Higher-rated bonds have a longer average maturity, and thus in moving towards higher-quality debt, investors are effectively removing some credit risk and extending the duration risk.

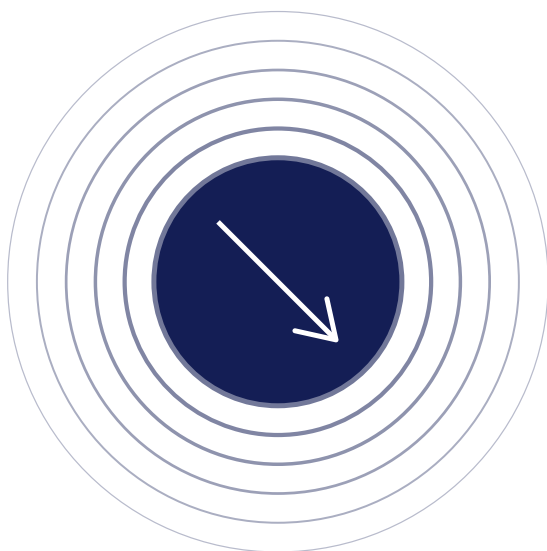
## Extending the duration risk

With the yield curve currently still inverted, investors may ask themselves what the appeal of longer-duration assets is when the yields on offer at the short end of the curve are higher. In our view, it is a matter of positioning for rate cuts, which should particularly benefit longer-duration bonds.

It is important to look ahead somewhat and consider how redemptions will be reinvested. As the name implies, short-maturity bonds provide a certain yield over a short time horizon, while longer-dated bonds lock in yields for a longer period. As we get closer

## Fixed income strategy adjustments

Decrease credit risk



Increase duration risk



**Source:** Julius Baer Investment & Wealth Management Solutions

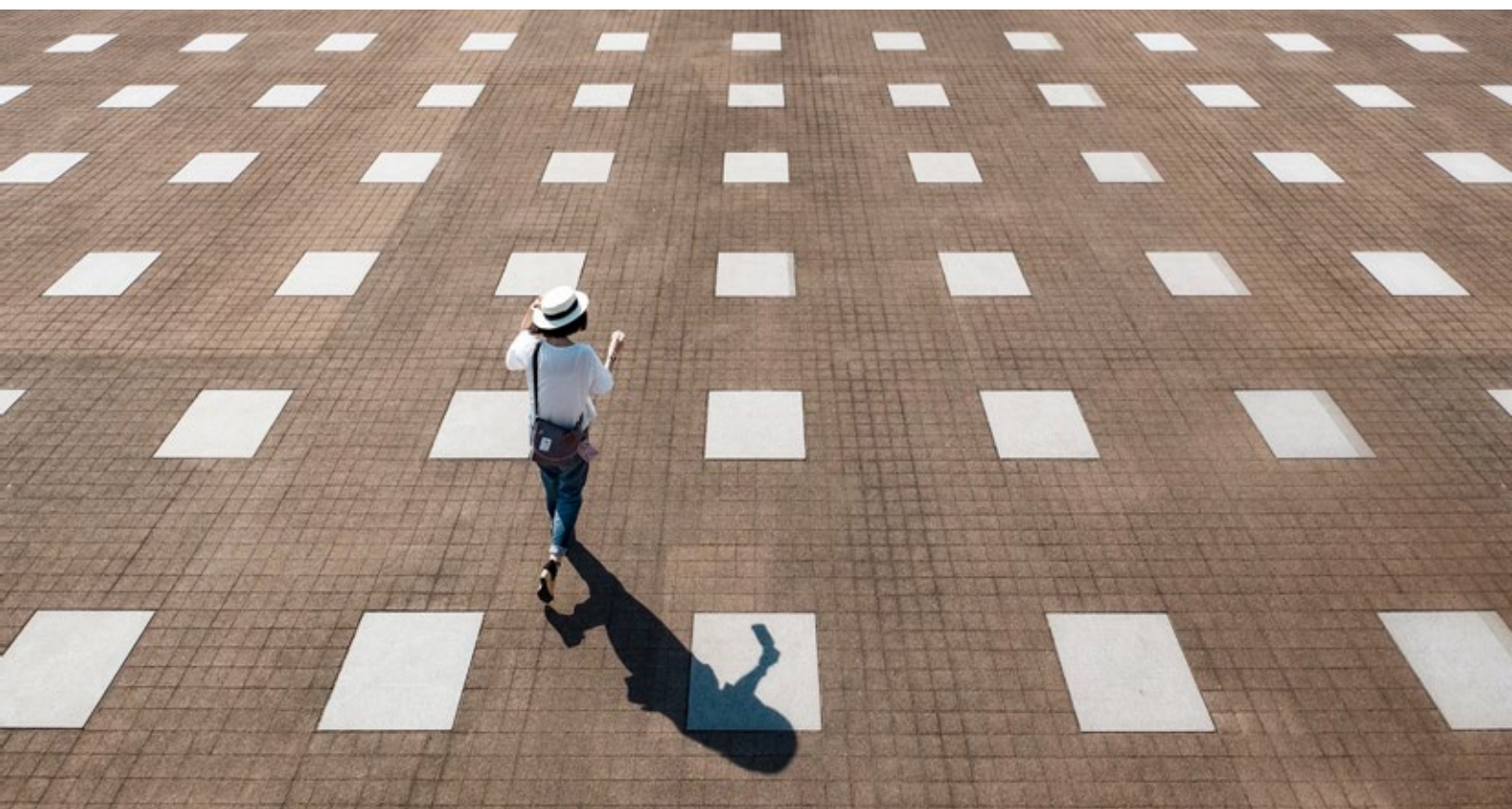
to the end of the tightening cycle, bond investors face increasing reinvestment risk – i.e. the risk of not being able to reinvest funds from maturing bonds at attractive conditions. By gradually extending the average duration in a bond portfolio now, the sensitivity to interest-rate changes can be diversified and the reinvestment risk for bonds that mature over the next two years can be reduced.

The exact level of targeted duration will always depend on an individual investor's circumstances and investment objectives. Furthermore, due to the volatility of yields, it would be appropriate to increase the average duration of a portfolio gradually through reinvesting redemptions into longer-duration bonds. Those who are comfortable with some volatility in their portfolio could start to add exposure to bonds with a duration of five to seven years. It should be noted, however, that it would not necessarily be appropriate for investors to hold these longer-duration bonds until maturity.

As a result of the factors outlined here, we now have an Overweight rating on USD high-investment-grade bonds. We would not sell high-yield bonds at the current spread levels but rather reinvest some redemptions of high-yield bonds into high-grade corporate bonds (AA or A grade). We are more cautious about adding duration to EUR bonds, as the rate-hiking cycle is more advanced in the US, and US inflation shows clearer signs of rolling over than in the eurozone. Consequently, risk-free yields are likely closer to their peak in the US, which implies more attractive upside potential than for EUR bonds.

#### Low-investment-grade bonds

We also maintain our Overweight rating for USD and EUR low-investment-grade corporate debt with shorter maturities. Such bonds may complement safer and longer-duration assets. Furthermore, a portfolio may benefit from the higher coupons that these bonds offer, and the default risk for this segment is low.



### Emerging market bonds

We would also consider adding emerging market bonds to a portfolio. Our fixed income analysts now see many drivers becoming more supportive for emerging market bonds. The gradual reopening of China should bode well for the country's bonds, which make up a considerable part of emerging market bond indices. Emerging market economies that rely on Chinese demand are also set to benefit now. Further tailwinds should be provided by expected rate cuts in the US in 2023, which should curtail the US dollar's strength. As a result of these factors, we upgraded emerging market hard-currency bonds to Overweight in December. However, we would keep a quality bias within emerging market hard-currency debt.

### Look out for...

Thinking a little further ahead, in the scenario of a recovering global economy, the time may come when it would be appropriate to move back down the credit-rating ladder, i.e. in terms of quality. In such a scenario, additional yield could be earned from some BB rated bonds, where company-specific developments point towards an upgrade by the rating agencies.

Overall, we anticipate that volatility will remain in the first few months of 2023, but once we have more clarity around the future paths of the US Federal Reserve and other major central banks, financial conditions should stabilise.

## Interested?



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The background of the slide features a high-angle, top-down view of a modern building's entrance. Two sets of wide, light-colored stone steps lead up to a glass-enclosed area. The steps are flanked by dense, vibrant green foliage, possibly ivy or similar climbing plants, which cover the building's exterior walls. The overall scene is bright and clean, suggesting a contemporary architectural style.

# Equities after the valuation reset

Based on our expectation of slowing global growth and lower inflation in 2023, as the new year begins, our preference within equities is for defensive quality stocks with a focus on the US.

During the year, a shift towards a more global, cyclical stance will be warranted to be well positioned to benefit from a recovery in 2023 and into 2024.

Thus, 2023 could well be the year of two very different market environments, where some good old-fashioned equity repositioning is required.

# Defensive quality first, cyclicals next

2022 will go down in history as the year in which equities fell – not because of a sharp fall in earnings, but rather due to geopolitical jitters and a drop in equity valuations due to higher interest rates. So, what should investors expect from 2023?

## At the outset of the year

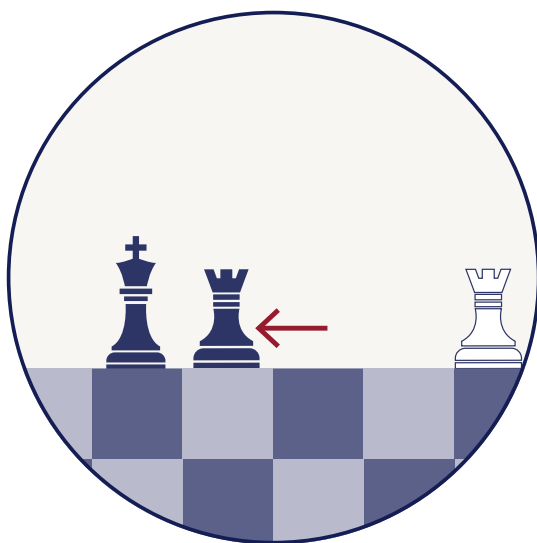
As we enter 2023, global growth is slowing and inflation remains elevated. Thus, companies are continuing to reduce their earnings expectations for this year. This favours defensive quality stocks, in our view. Some of their attributes are strong product differentiation, quality balance sheets, high free cash flows, and strong customer loyalty. However, our focus is not purely on quality but rather on companies with defensive business models, especially given our expectation of slower growth ahead. Taking a closer look at the sector level, one can observe that many high-quality companies can be found within

healthcare and those consumer goods that are required throughout an economic cycle.

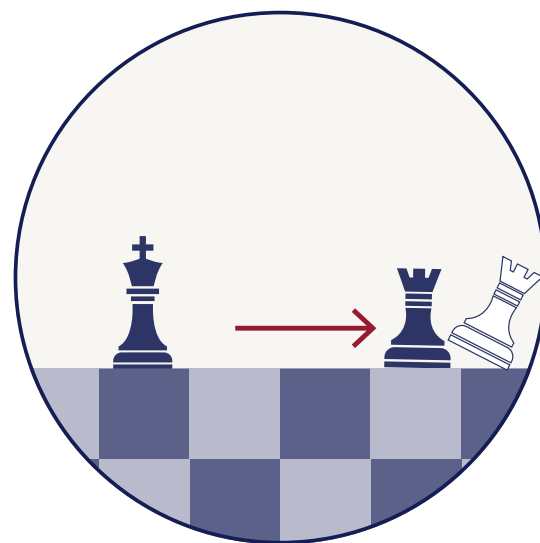
In fact, healthcare remains our most preferred defensive sector, with a focus on large-cap pharmaceutical companies (including biotech). This segment consists of many high-quality companies whose superiority is evidenced by sustainable competitive positioning and the high demand for their products in both good and bad times. Thus, large-cap pharmaceutical companies have strong pricing power. Moreover, given the sector's low sensitivity to input costs, still high inflation is less of an issue. However, not all healthcare subsectors are

## Our equity playbook for 2023

Position defensively first...



...and then take the offensive with cyclicals



Source: Julius Baer Investment & Wealth Management Solutions

defensive in nature. There are also cyclical segments, such as MedTech and life-science tools, and these may well become the more interesting segments as the year progresses.

In terms of regional preferences, our focus is initially on US equities given that growth in the US is expected to hold up relatively well as compared to Europe, and we expect further interest-rate increases in the eurozone as well.

#### As the year progresses

In our Market Outlook Year-End 2022, we highlighted that opportunities in equity markets could open up before the economy reaches a low. In fact, what is needed is a positive change, but what could this look like in 2023? As the year progresses, it could become more and more apparent that the cooling in economic activity is also cooling down inflationary pressures. This portends a positive cyclical dynamic for equities, as it should allow central banks to back-pedal on some of their monetary tightening. As economic activity begins to stabilise, this should open up opportunities in cyclical markets

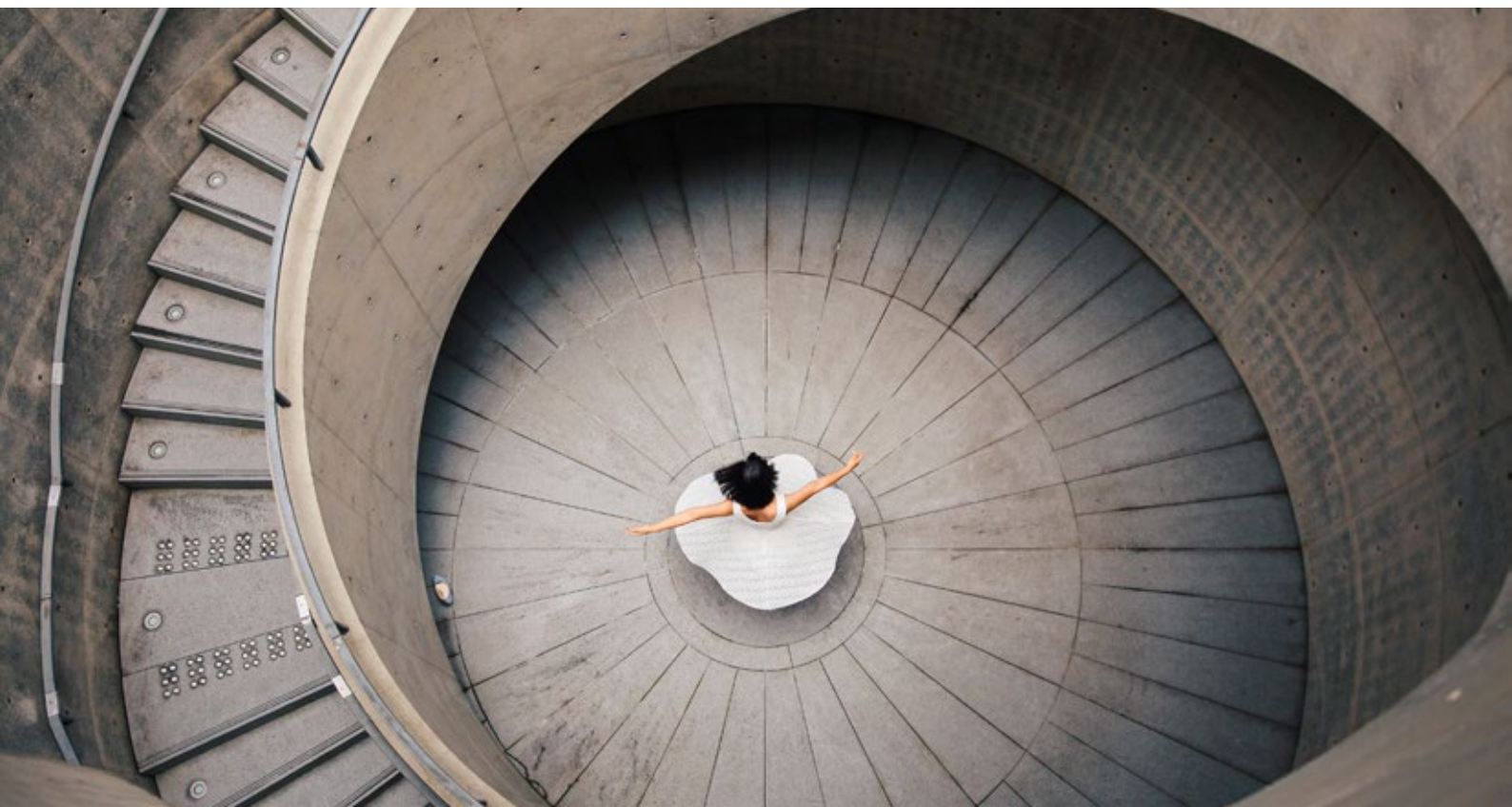
## Video

Please watch our **video on the healthcare sector**, where Mathieu Racheter, Head of Equity Strategy, explains why the sector offers compelling opportunities throughout 2023.





across the globe, e.g. export-dependent European equities, with their positive exposure to global growth; small-cap stocks, which tend to be more cyclical than the more diversified large-cap stocks; and bottom-up cyclical opportunities across varied sectors, such as automotives, machinery & equipment, and logistics.



### What about emerging markets?

For those looking for opportunities beyond developed markets, India, with its strong underlying growth trends and large domestic market, remains a long-term winner. Furthermore, in Southeast Asia, corporate earnings are resilient and there is a high proportion of local-currency-denominated debt, which means that the region is less exposed to rising US interest rates. It is thus a worthwhile consideration for those looking for some diversification.

As is the case for developed markets, cyclical opportunities are likely to arise in emerging markets throughout the year as well. First and foremost, Latin American equities, with their highly cyclical sector composition, come to mind. Overall, emerging markets could well make a comeback in 2023, since they trade at a discount and benefit disproportionately from a growth pickup, stable commodity prices, and a weaker US dollar. In fact, a persistently weaker greenback could be an all-clear signal for emerging markets, as it would show that global liquidity is on the rise again. Developments in China could also shape the year.

## Interested?



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Special

# China reopening: A major wild card for global markets in 2023

After nearly three years of the world's strictest Covid-19 containment measures, with the effects reverberating through the global supply chain, including those sectors reliant on Chinese business, the Chinese economy is beginning to see some relief. So what now? Here is what we expect.

As the adage goes, it is darkest before the dawn. This may be true for China as well, but it is currently debatable. On the one hand, the Chinese government is taking steps to reopen international borders and relax quarantine restrictions, but on the other hand, the country is experiencing a major wave of Covid-19 infections. The reopening measures should boost travel, trade, and domestic consumption, but it remains to be seen whether the health system can keep up. With many unknowns still in play, China's reopening will most likely be one of the major drivers of asset prices in 2023.

Predictions are hard to make at this point, but assuming no major escalation of the Covid-19 situation, we anticipate moderate economic growth in China in 2023 and believe that policy stimulus will allow the market to extend the year-end rally of 2022 into the early part of this year. In fact, China's policymakers will stay accommodative as long as the economy is weak. Ironically, bad economic data may actually be beneficial for the market.

As indicated at the recent annual Central Economic Work Conference, promotion of growth will be the government's top priority for 2023. The focus will be on expanding domestic demand, promoting the recovery of consumption, and reviving confidence. Further, policymakers aim to stabilise the troubled property sector but remain worried about excessive debt and are unlikely to completely reverse their stance. With regards to Covid-19 policies, it is clear that the priority has shifted to controlling the number of severe cases rather than the overall number of infections. In this context, value and cyclical stocks may lead the rally, with stocks in the internet and property sectors likely to outperform.

Meanwhile, China will continue to push its long-term initiatives. Should the economy recover and gather strength in the later part of this year, we may see some reform policies being rolled out. The equity market may then return to a 'fat and flat' trading range, i.e. an overall sideways trend with large moves that may provide trading opportunities. Investors should focus on thematic and sector opportunities rather than overall market returns. We reiterate our long-term preference for the environment, mass consumption, and smart manufacturing.

Special

# Next Generation: Preparing for the next cycle

The aim of our Next Generation investment philosophy is to identify global megatrends and transform them into tangible investment themes. While thematic investments suffered due to the valuation reset last year, some have been better shielded. We take a closer look and outline how to be best positioned while preparing for the next cycle.

The focus within our Next Generation themes is on companies in structurally growing industries, and we select those with a competitive advantage, as they are most likely to benefit from the identified trends. The emphasis is primarily on profitable growth companies. In fact, this helped to partly shield our Next Generation themes during the sell-off last year, since non-profitable thematic growth companies were the ones that experienced some of the worst losses.

In fact, 2022 was about a repricing in the market for any kind of investment with a longer-term investment horizon, as interest rates rose relentlessly. The resulting drop in valuations means that many of our Next Generation themes are now trading below their pre-pandemic valuation average.

At the same time, the long-term structural trends that underpin our Next Generation thematic themes were not fundamentally altered last year. Rather, it was quite the opposite: in some cases, events in 2022 actually strengthened the investment case for certain themes.

With this in mind, the time has come to prepare for the next cycle for Next Generation thematic investments. As 2023 begins, we will thus focus on the following three Next Generation themes:

## Energy Transition

The energy transition to renewable energy production is shifting up another gear, as Europe is determined to reduce its dependency on oil and gas from Russia. Meanwhile, cost inflation looks like it is under control. Within this theme, a somewhat unexpected beneficiary this decade could well turn out to be copper, as it is a critical component of the batteries that drive electric cars. This should translate into strong demand for the metal just as mine-supply growth is slowing.

## Shifting Lifestyles

The trends of an ageing society, as well as scientific medical and digital innovations, are ongoing, and after the valuation reset of last year, the theme is attractively valued. In particular, the subthemes of Digital Health, Extended Longevity, and Genomics look particularly promising.

## Future Cities

Investments continue to make their way into the buildout of more digital cities and a more circular economy, making this among the least cyclical of the Next Generation themes.



# Additional sources of return

Given the high volatility in public markets, investors can consider alternative investments, such as private market investments and hedge funds. These are ways to access additional sources of return and have the potential to improve the risk/return profile of a portfolio.

Private market investments provide an important gateway to a growing set of real assets and can offer investors different premiums as compared to traditional investments.

Hedge fund strategies can utilise the rich opportunity set arising from macroeconomic volatility and external shocks due to their ability to invest in various asset classes and to go both long and short.

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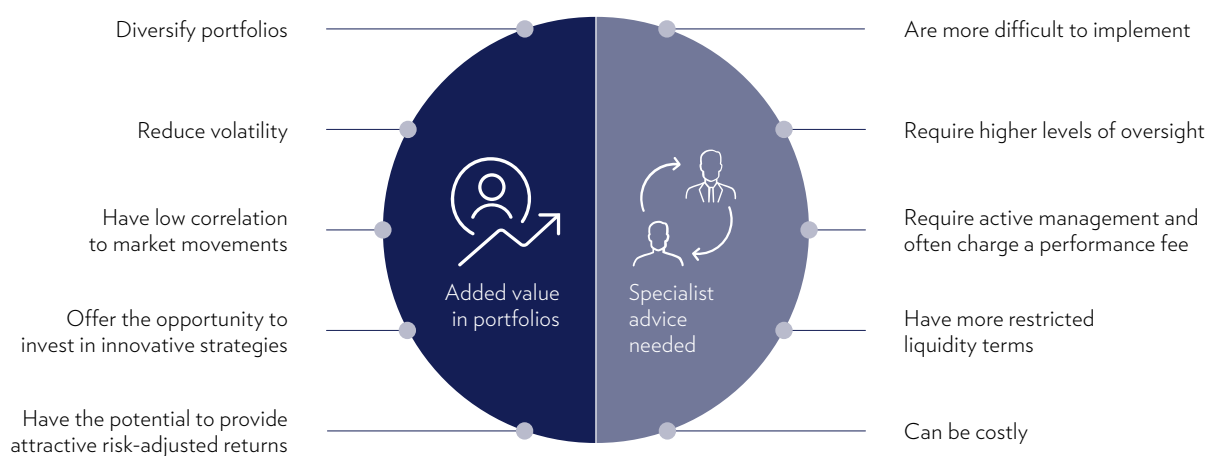
# Consider alternative investments

Investors could consider alternative investments, such as hedge funds and private market investments, as additional sources of return in a well-diversified portfolio. Our experts give their insights on these investments and on how investors might benefit from them.

Active management is set to play a greater role in adding value for investors in 2023 and beyond. As part of a well-diversified portfolio, alternative investments such as hedge funds and private market investments can provide additional sources of return for investors. Through these asset classes, investors can access opportunities that are not available in public markets, and the breadth of the asset class also means that there are opportunities throughout

the cycle. However, there is much more variation in returns across different managers in the alternative investment space, and thus selecting specialists with the right experience and skillset to manage these investments is crucial. We put five questions to Julius Baer's Simon Ibbitson, Head of Private Markets Fund Distribution, and Adrienne Jaersvall, Head of Fund Advisory, to find out more.

## Characteristics and objectives of alternative investments



**Source:** Julius Baer Investment & Wealth Management Solutions

# Private markets

Interview with Simon Ibbitson, Head of Private Markets Fund Distribution at Julius Baer

## 1. What are the main characteristics of private markets and how do they differ from investments in public securities?

Private markets provide investors with access to non-publicly listed assets, covering private equity, private real estate, infrastructure, private debt, and even natural resources. Private equity is the largest subset of the private market asset class and refers to investments in non-publicly listed companies.

Private equity investments are most commonly made through closed-ended funds, which typically have a lifetime of around ten years. Rather than investing the full amount at the beginning, a private equity investment starts with a capital commitment. This is then called for investment by the managers, who will deploy it over what is known as the investment period, which usually lasts three to five years. The investments are then held for another three to five years, whilst the latter stage of the fund's life is used to create value in the underlying positions and prepare the assets for an exit. Returns only

materialise when the underlying investments in a fund are exited.

Private equity is an illiquid asset class and not one where you can buy today and sell a few days later, as would be possible with public equities. One fundamental difference between private equity funds and mutual funds is that the decision to buy and sell the underlying investments is effectively 'contracted out' to a private equity fund manager. There is a secondary market for private investments, where there is some degree of liquidity, but selling in the secondary market may mean having to accept a discount to the net asset value, depending on the market environment at the time.

Other differences include the availability of information. There is a higher degree of information asymmetry in private markets given the nature of non-listed companies. However, the volatility of private market assets tends to be much lower than for their listed counterparts, primarily because the assets are valued less frequently, i.e. on a quarterly basis.

## 2. What about the illiquidity aspect often associated with private markets?

Well, let us consider whether illiquidity is actually a drawback – I think the fixation of having a wholly liquid or actively tradeable investment portfolio in the belief that such a portfolio is superior is a little misguided. It is important to have a blend. So, from a portfolio management perspective, it is a balancing act, and when financial planning allows, an allocation into illiquid investments with potentially higher return expectations can make sense. In my view, the illiquid nature of this asset class and the fact that the buying and selling decisions are 'contracted out' are perhaps the most appealing aspects of private market investing. The lack of liquidity creates more stability, and it is not possible for emotionally driven, irrational short-term decisions to come into play.



### 3. Which areas within the private equity space are particularly attractive at the moment and why?

This is a question we often hear, and my first response is that we tend not to try and time the private equity business with ‘what’s hot and what’s not’. We tend to look at trends; but what is interesting today might pass in, say, the next 12 months, and another trend may appear. One can do this with better effect in public markets, but not so much in private ones. A commitment today is an investment tomorrow, and the capital may well be invested over several years, in an ever-changing economic and political environment. That said, some strategies are more applicable than others at different times. For example, I think 2022 will prove to have been a prodigious performance year for private equity secondary managers, i.e. those firms that buy fund interests from existing owners who are looking to sell for whatever reason. Given the deterioration in all asset prices, 2022 was a buyer’s market, and some very attractively priced assets have been acquired by these secondary managers.

The illiquid nature of this asset class is perhaps one of the most appealing aspects of private market investing.

### 4. There are some concerns about a lack of transparency in the private market industry. What are your thoughts on this?

Well by nature, there is information asymmetry in the private markets space. Companies do not publish regular reports and there is less media coverage. So inherently, there is less public information in private market investing. However, it is a myth that public companies are more transparent because daily share price moves can be observed and quarterly (or at least half-yearly) reports are published – there is actually only a limited amount of information that managers of public companies do share. With private companies, on the other hand, there is a large amount of information that private equity managers can share with investors about the

companies in which they are invested, unless the information is commercially sensitive.

### 5. Why should investors consider making an allocation to private market investments?

I believe that it is appropriate for investors to consider making an allocation to private markets, because these investments would complement public-market investments within a portfolio. Of course, each individual investor’s objectives and risk tolerance must be considered, but in my view, the growth of private capital and the important role that this plays in successful economies fostering innovation, job creation, and generating profitability are just too big to ignore.

Private markets can increase diversification in a portfolio, as they are typically not highly correlated to other asset classes and in theory offer different premiums (e.g. illiquidity and information asymmetry premiums) to expected base returns. Moreover, they offer access to opportunities and companies that are not available in public markets.

It is also important to note, however, that the variation in returns in private markets is much greater than in other asset classes, so manager selection is key. A deep and experienced skillset is required to source, acquire, manage, and exit these investments, which is why investors will typically seek exposure to private markets through closed-end private equity funds that are managed by well-experienced fund managers.

## Podcast



Listen to the **podcast** with Simon Ibbitson and Michael Hornung-Moser on private markets.



# Hedge funds

Interview with Adrienne Jaersvall, Head of Fund Advisory at Julius Baer

1. What are the main characteristics of hedge funds, and how do they differ from investments in public securities?

Hedge funds can generally make use of any and all investment opportunities at their disposal. These can range from public to private equities, government bonds to private credit, or commodity indices to niche energy contracts. The big differentiator to investments in public securities is that they can short such securities. This in turn means that they can, in theory, make money in an environment where asset prices fall in value.

The second important point to note is that hedge funds can use leverage, meaning that they can borrow money to increase the potential return of an investment. The other side of this coin, though, is that the risk of potential losses also increases, which is why the use of leverage should be carefully managed and generally limited.

2. What about the illiquidity aspect often associated with hedge funds?

Hedge funds' liquidity profiles can range from daily liquidity to annual liquidity or less. The level of liquidity will depend on the underlying instruments traded. For example, funds with a focus on liquid large-cap equities will likely be much more liquid than funds that focus on distressed credit or a form of private market assets that have no secondary market. It is worth noting that there is an illiquidity premium attached to less liquid funds (which allow for client withdrawals once in a quarter) and that they tend to show stronger alpha generation – i.e. return generation beyond traditional market returns. This is related to the fact that information in less liquid markets can be so much more difficult to obtain and analyse.

3. Which areas within the hedge fund space are particularly attractive at the moment and why?

Interest in hedge funds came roaring back with the return of volatility in late February 2020, after a



decade of lacklustre performance as a result of low volatility and a bull market that was partially fuelled by quantitative easing. Last year, hedge funds outperformed a traditional portfolio consisting of 60% equities and 40% bonds by more than 10%, as many hedge funds were flat or positive for the year. With heightened volatility and a higher interest rate environment likely here to stay, we expect relative-value strategies to do well. These are 'old-school' hedge fund strategies and investment styles that thrived in the 1990s/2000s and were subsequently suppressed by the absence of volatility and low interest rates. Furthermore, their large unencumbered (unused) cash holdings are often invested in short-term Treasury bills, which allows them to generate additional returns due to currently higher interest rates.

Thanks to the end of quantitative easing, the return of heightened volatility, and higher interest rates, we see a very attractive opportunity set for relative value strategies.

To give an example: Relative-value strategies can include fixed income instruments, equity instruments, and more complex option strategies to benefit from volatility. Managers of a relative-value strategy try to predict a change in the relationship between the price or rate of two investment instruments. For instance, when a company announces that it wants to buy another company, the target company's stock price typically increases but then settles below the price being offered. As the date of the closing of the merger deal edges closer, the stock price of the target company will move towards the offering price. The investor will buy that stock just as the deal is announced and hold the stock until the deal closes to sell it at a profit. That is a so-called merger-arbitrage trade.

#### 4. There are some concerns about a lack of transparency in the hedge fund industry. What are your thoughts on this?

It is true that hedge funds often do not publicly disclose their portfolio positions and the frequency at which they trade in order to maintain a competitive advantage. Our process includes extensive investment and operational due diligence, which allows us to obtain a great deal of transparency. We continue to maintain a high level of visibility when speaking to hedge fund managers on a monthly basis. It is worth noting that today hedge funds are audited and registered with financial authorities such as the US Securities and Exchange Commission, and that administrator reports are available to us as well.

#### 5. Why should investors consider making an allocation to hedge funds?

'Goodbye QE, hello RV', is the story in a nutshell. In our view, relative-value (RV) strategies continue to offer a very attractive opportunity set, due to the end of quantitative easing (QE) by central banks, the return of heightened volatility, and higher interest rates. They also typically display a limited market correlation and so they can do well in volatile markets and protect clients' portfolios.

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# Further information

Please find below further information on benchmarks and indices used in the review section of this Investment Guide.

## Market Review

### Equity regions

Region	Index
Emerging markets excluding China	MSCI Emerging Markets excluding China Net TR USD
Switzerland	MSCI Switzerland NR CHF
Eurozone	MSCI Europe Net TR EUR
China	MSCI China Net TR USD
USA	MSCI USA Net TR USD
Japan	MSCI Japan NR JPY
UK	MSCI United Kingdom NR GBP

Note: NR = net return, TR = total return

### Equity styles

Style	Index
Quality	MSCI World Quality Net TR USD
Value	MSCI World Value Net TR USD
Growth	MSCI World Growth Net TR USD
High dividends	MSCI World High Dividend Yield Net TR
Cyclicals	MSCI World Cyclical Sectors TR USD
Defensives	MSCI World Defensive Sectors TR USD
Small caps	MSCI World Small Cap Net TR USD
Large caps	MSCI World Large Cap Net TR USD

Note: TR = total return

### Equity sectors

Sector	Index
Information technology	MSCI World Information Technology Net TR USD
Materials	MSCI World Materials Net TR USD
Oil & gas	MSCI World Energy Net TR USD
Industrials	MSCI World Industrials Net TR USD
Communications	MSCI World Communication Services Net TR USD
Healthcare	MSCI World Health Care Net TR USD
Financials	MSCI World Financials Net TR USD
Consumer cyclical	MSCI World Consumer Discretionary Net TR USD
Consumer defensive	MSCI World Consumer Staples Net TR USD
Real estate	MSCI World Real Estate Net TR USD
Utilities	MSCI World Utilities Net TR USD

Note: TR = total return

## Fixed income

Segment	Index
US government bonds	Bloomberg US Treasury Total Return Unhedged USD
US TIPS	Bloomberg US Treasury Inflation Notes TR Index Value Unhedged USD
DM high investment grade	Bloomberg Barclays Global Aggregate Aa TR Value Unhedged USD
DM low investment grade	Bloomberg Barclays Global Aggregate Baa TR Value Unhedged USD
DM high yield	Bloomberg Barclays Global High Yield TR Value Unhedged USD
USD floating-rate notes	Bloomberg US Floating Rate Notes TR Index Value Unhedged USD
EM hard currency	Bloomberg Barclays EM Hard Currency Aggregate TR Value Unhedged USD
EM local currency	Bloomberg Barclays EM Local Currency Government TR Unhedged USD

Note: DM = developed markets, EM = emerging markets, TR = total return

## Commodities

Commodity	Future
Brent crude oil	Generic 1st 'CO' Future, ICE Futures Europe Commodities
US natural gas	Generic 1st 'NG' Future, New York Mercantile Exchange
Gold	Generic 1st 'GC' Future, Commodity Exchange, Inc.
Silver	Generic 1st 'SI' Future, Commodity Exchange, Inc.
Platinum	Generic 1st 'PL' Future, New York Mercantile Exchange
Aluminium	Generic 1st 'LA' Future, London Metal Exchange
Copper	Generic 1st 'LP' Future, London Metal Exchange
Iron ore	Generic 1st 'SCO' Future, Singapore Exchange

Note: 1st = front month futures contract

## Scoring our Calls

Topic	Benchmark index used
Fixed income – moderate credit risk	ICE BofA 1-10Y US Corporate TR Index
Barbell approach to stocks – value stocks	MSCI World 50% hedged to EUR
Barbell approach to stocks – growth stocks	MSCI ACWI Information Technology NR USD
Stocks with a defensive tilt – US stocks	MSCI North America NR USD
Stocks with a defensive tilt – high-dividend US and Asia	50% MSCI USA High Dividend Yield Index/ 50% MSCI AC Asia Pacific excluding Japan High Dividend USD Index
Stocks with a defensive tilt – healthcare stocks	MSCI ACWI/Health Care NR USD
Clean Energy	MSCI ACWI NR USD
Future Mobility	MSCI ACWI NR USD
Environment	MSCI World Select Reduced Fossil Fuel USD Index
Stocks set to recover – information technology	JB NG Cloud Computing & AI Index
Stocks set to recover – digital health	JB NG Genomics Index
Fixed income – quality high yield	ICE BofA Global HY Constrained TR
Fixed income – deeply subordinated bank debt	Barclays Benchmark Overnight USD Cash
Stocks to own	MSCI North America NR USD
Pets – an unbroken trend	MSCI World TR EUR
Macro hedge fund strategies	HFRI Fund of Funds Composite Index

Note: AC = All Country, ACWI = All Country World Index, AI = Artificial Intelligence, BofA = Bank of America, HY = high yield, NG = Next Generation, NR = net return, TR = total return



# Imprint

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