Investment strategies for uncertain markets

Geopolitical tensions and economic uncertainty are threatening market stability, yet many investors remain unprepared for the challenging times ahead. Private markets and private debt offer an attractive alternative for pension funds and institutional investors in general

The uncertain political and economic climate is creating challenges for many investors.

The war in Ukraine and subsequent international sanctions against Russia, renewed tensions between the US and China, the rise of widespread protectionist trade policies, the Covid-19 pandemic and Brexit have all contributed to inflationary pressures.

Forecasters initially saw this as a temporary situation. But there are now concerns that inflation is entrenched and risks are becoming structural.

A more inflationary environment could cause central banks to increase interest rates faster and further than previously expected, which in turn could lead to a period of below-trend or negative growth in the UK and many other regions.

This obviously presents a serious challenge for investors. Despite equity and bond markets showing volatility over the past 12 months, they do not yet seem to be reflecting these more negative long-term outcomes.

The consensus estimate for equity markets in the US, for example, is year-over-year earnings growth of 9 per cent next year. But a recession could see double-digit declines. Recession risks from rising policy rates are lower in the eurozone, but this region still faces significant economic threats, not least the prospect of Russia cutting off gas exports this winter.

Investors need to look carefully at these longer-term inflationary pressures across different markets when managing the risk-reward profile of portfolios. Alpha returns may be harder to deliver in an economic slowdown, but with diversification into less liquid assets there is still the potential to deliver market-beating returns in this more challenging environment.

Bleak economic forecasts for the US and eurozone

Inflationary pressures are affecting both fixed income and equity markets in the US and eurozone.

The US is experiencing the greatest imbalance between labour demand and supply since the 1970s. The US Federal Reserve's strategy has been to raise rates to weaken demand and remove these excess jobs without driving up unemployment figures. However, the Fed acknowledges that the desired 'soft landing' will be difficult to engineer.

Interest rates are likely to continue to rise until there is clearer evidence that inflation is starting to come under control. We predict that the central bank rate will stand at 4 per cent by the end of 2022, which is higher than market pricing at present.

Additional hikes in 2023 are possible, depending on whether inflation is softening and growth emerging in the US and other major economies. This will have an impact on US fixed-interest

market yields, and the prospect of higher rates choking off economic growth and potentially causing recession is likely to cause further volatility in equity markets.

In the eurozone, energy remains the main focus, with concerns that a 10 per cent cut in gas supply from Russia could reduce growth by 0.7 per cent. A total shutdown of Russian gas imports could lead to a severe recession, with high inflation the inevitable outcome.

The risks around eurozone core inflation are more mixed than in the US. Momentum in non-energy industrial goods inflation has slowed somewhat as Covid restrictions in Asia have eased. Business inventories have started to build while consumer demand slows.

However, services inflation will remain high in the near term and labour shortages due to pandemic disruptions are continuing to boost wages. This could fuel further inflation if wage settlements are tied to cost-of-living adjustments.

The European Central Bank's recent upward adjustments to inflation forecasts still look far too optimistic when compared to the recent price increases. The bank will therefore likely have to revise its projections in September, which means the outlook for interest rates in the eurozone remains highly uncertain.

We believe inflation is unlikely to turn around anytime soon in this region. It expects headline inflation to peak in September at around 9 per cent, with risks remaining on the upside.

Diversification into private markets

Higher inflation, raised interest rates and slower growth will impact both fixed income and equity markets in the US and eurozone. This may prompt many institutional investors to consider diversification strategies that embrace other asset classes, including private markets and private debt. Those who already have exposure may want to look at increasing or broadening their allocation to this asset class.

Private market and private debt investments offer obvious attractions in terms of diversification. Returns are less correlated to equity/bond holdings and they enjoy a premium for being less liquid investments. As defensive, non-cyclical income streams, they are resilient even in slowing economies and are an effective way to enhance the risk/return profile of a portfolio, even against a challenging economic backdrop.

Institutional investors have a broad range of strategies to choose from within this asset class, including infrastructure debt, SME lending, real-estate debt and credit risk sharing.

Within each is the potential for further diversification in terms of geographic and currency exposure, alongside options on the capital spectrum – be they duration, fixed and floating rate options, or senior, mezzanine and junior debt.

Many of these strategies are well positioned to deliver growth across both the medium and long term. One important area of growth is likely to come from the switch towards a greener, lower-carbon economy as economies, governments and companies strive to reach net-zero targets.

The current state of political instability is likely to accelerate this trend. While there may be short-term boosts to domestic fossil fuel production in both the US and the eurozone, this is likely to be accompanied by increased investment into renewable-energy infrastructure and storage options.

This is a growth area, with a number of funding opportunities for private debt and private market asset managers and their institutional investors. As well as presenting exciting investment opportunities, private debt investments have attractive ESG characteristics.

BNP Paribas Asset Management has built up considerable expertise in private market and private debt investments, with specialist teams working across these different strategies. The range of investment options on offer at different risk and return levels are all viewed through an ESG lens.

Global tensions continue to present a challenging backdrop for investors, with higher inflation and slower growth creating a less benign economic reality. For those looking to the medium to long term, there may be a need for greater diversification and exposure to assets that offer more defensive qualities alongside attractive risk/return profiles.

Private markets and private debt investments are an attractive option for investors looking for some safety as well as returns during a changing economic climate.

Written by BNP Paribas Asset Management head of investment specialists, private debt and real assets, Timothy Li

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