APRIL 2023

Listening for the quiet

Leveraging our Allview approach of seeking diverse and unique perspectives to uncover pockets of opportunity in the equity markets

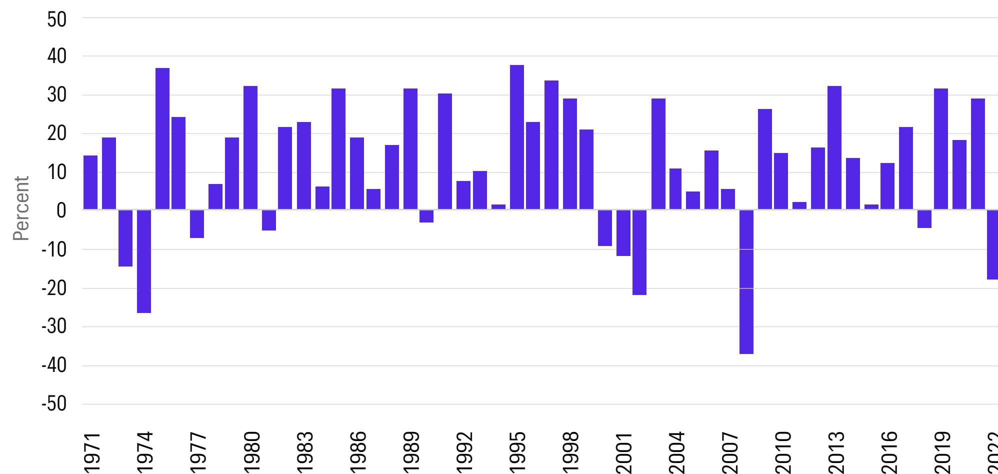
ANN MILETTI,
Chief Diversity Officer,
Head of Active Equity

The start of 2023 has hardly been calm for equity markets. The confidence behind January's strong bounce quickly morphed into anxiety about many of the same macro risks that dogged investors last year: Inflation and interest rates have remained stubbornly high, tightening credit standards are sapping consumer strength, and jobless claims are rising. Recent bank failures and distress across the financial system have only added to concerns about economic growth prospects. It's not clear whether a recession will officially be declared, but it is clear that we've entered an earnings recession—S&P 500 earnings are in the midst of a two-quarter decline.

> "It's not clear whether a recession will officially be declared, but it is clear that we've entered an earnings recession ...

A lot of bad news and negative sentiment have already been impounded in prices. The S&P 500 Index was down 18.1% in 2022, its fourth-largest annual decline since 1971. Will 2023 look more like the rare, grinding drawdowns of 1973 or 2000, or will it be similar to the more common, cathartic resets of other years? There's no ready analog for today's markets, but we do know that it's rare to experience consecutive years of broad market declines.

S&P 500 INDEX ANNUAL RETURNS SINCE 1971



Source: eVestment, as of December 31, 2022. **Past performance is not a reliable indicator of future results.**

There are some notable bright spots on the horizon. Valuations have fallen from nosebleed levels, and steady deterioration in reported earnings has lowered the bar for positive surprises down the road. Moreover, relative valuations for non-U.S. developed markets and emerging markets have been attractive for some time. From a macroeconomic perspective, we've all seen how one data release can immediately flip sentiment toward a recovery narrative.

Although predicting exactly what's around the corner may be impossible, **listening for the quiet** is essential for controlling portfolio risks. Our fundamental approach, combined with active management, is grounded in time-tested investment strategies. The bottom-up stock selection work of our investment teams has led them to quality fundamentals. For example, strong balance sheets, stable-to-growing free cash flow per share, and management teams with good risk controls and who have managed through challenging times are creating separation that can be exploited by active approaches. I believe a quality bias will carry a higher premium in the current cycle than it did in the last one.

Against this backdrop, I have three suggestions for investors as they consider their positioning. First, **know your personal risk tolerance**. For many people, this will be finding the market exposure today that balances fears of further market declines against fears of missing out on the early stages of a market rebound. Trying to time market moves often hasn't worked out well for investors in past cycles, so don't repeat their mistakes. Second, **consider diversifying globally**. Regional market dynamics play out at different paces, and the character of a rebound is likely to reflect this divergence. Third, **take a look at what the market offers today**. Within your market-risk budget, consider overweighting areas that offer the best value. In this spirit, I've asked three of our portfolio managers to cut through the noise and identify pockets of opportunity within their areas of specialty.

Derrick Irwin, CFA

Portfolio Manager, Intrinsic Emerging Markets

Three trends are quietly shaping the investment landscape in emerging markets. The first is that the pace of foreign direct investment (FDI) in China has been slowing for several years. It's currently at a decade low as multinational companies look to diversify their manufacturing footprint for global export markets. We view this as a "China plus one" strategy, as companies choose to sustain or transform existing capacity in China for domestic consumption. While there are several nations poised to enjoy higher FDI as a result, Mexico looks particularly interesting. It has wage costs on par with China, much lower transport costs, and lower trade barriers within North America under the U.S.-Mexico-Canada trade agreement signed in 2020.

The second is that Chinese companies are choosing to relocate production to reduce costs and trade risks with developed markets. Mexico is one beneficiary, but Southeast Asian nations are more often a preferred target for Chinese FDI. Structurally, China's growth is slowing, and we expect gross domestic product growth to fall toward the 3% to 5% range over the next several years. In many ways, China is taking a page from Japan's playbook from the 1980s and 1990s—looking for new markets, new sources of growth, and new places to invest in its backyard. This is a "slow burn," but at the margin, Southeast Asian countries—particularly large markets such as Indonesia—should be long-term beneficiaries of this trend.

Finally, regional factors are playing a much more important role in driving return dispersion within emerging markets. Countries with very different structural drivers had been at the mercy of Federal Reserve (Fed) policy and the strength of the dollar in the past few years, causing them to trade as a block. However, this has dissipated over the past six months. Today, greater dispersion benefits investors by offering better opportunities for diversification and an improved landscape for stock selection.

Chris Miller, CFA

Senior Portfolio Manager and Team Lead, Select Equity

Last year's shift to a higher-rate, higher-inflation environment has caused many investors to seek out inflation-resilient areas like commodities and energy stocks. Often overlooked in this process are real estate investment trusts (REITs), which have performed well in similar historical environments. Because REITs can eventually pass through price increases to tenants, their dividend growth can potentially provide income levels that keep up with inflation. REITs also enjoy some natural protection from would-be competitors due to the increasing costs of labor and capital to build new supply or due to regulatory, physical, or social barriers that can discourage new construction of certain property types.

REITs aren't impervious to systematic risks. In the short run, sharp interest rate increases, like those experienced in 2022, can cause levels of volatility similar to stocks. For example, the rise in the 10-year Treasury yield from 1.51% to 3.88% in 2022 corresponded to a 25% decline in the FTSE NAREIT All Equity REIT Index. Over longer periods, however, REITs have offered significant portfolio diversification benefits. They had a 0.59 correlation to the S&P 500 Index and a 0.10 correlation to the 10-year Treasury over the past 50 years (ending 2022). REITs also offer important diversification benefits due to diverse characteristics among various REIT subsectors, geographies, and tenants.

Domestic infrastructure spending should proliferate in the coming years, benefiting REITs. Subsectors like cell towers and data centers could garner demand from spending on 5G networks and additional spectrum. We expect industrial warehouse capacity will be in high demand around newly invigorated manufacturing hubs. Longer term, other REIT sectors should benefit from pent-up and growing demand for housing, including self-storage and other subsectors. In general, listed REITs have offered investors diversification, inflation resiliency, and higher yields in their broader portfolios. Considering the sharp valuation reset REITs experienced in 2022, we believe the asset class offers the potential for strong returns in the years ahead.

Mike Smith, CFA

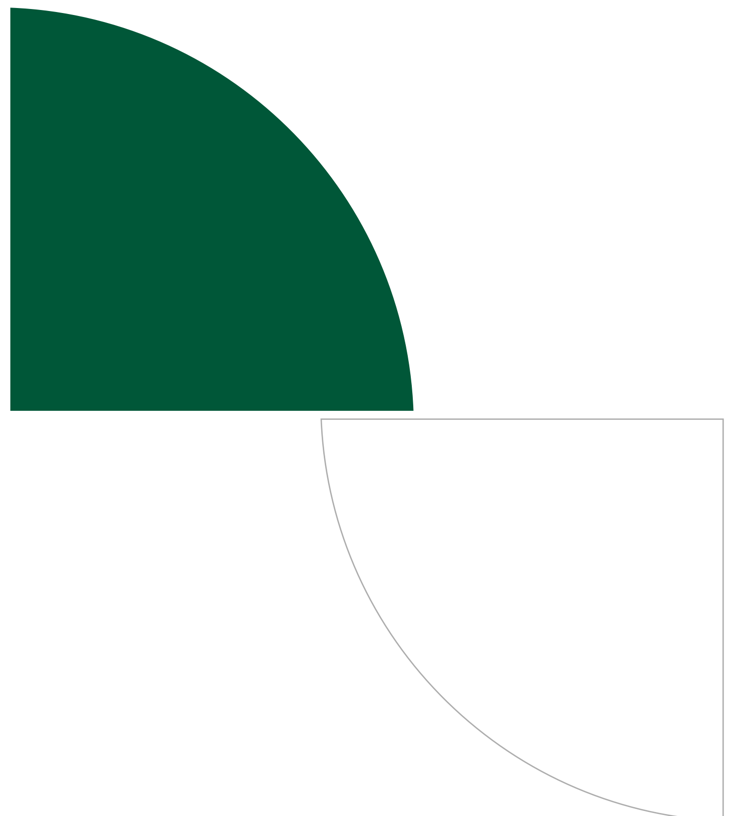
Managing Director and Senior Portfolio Manager, Discovery Growth Equity

Recent headlines for U.S. equities have felt dispiritingly similar to 2022: hot inflation, further tightening by the Fed, rising rates, and lingering fears of recession. These factors brought severe pain to growth stocks last year, but market leadership has shifted sharply toward growth stocks this year, even as interest rate increases have continued. Earnings season contains clues to why this has occurred.

First, pessimism ran rampant late in 2022 for many stocks within growth-oriented sectors, such as information technology, communication services, and health care. Amid falling stock prices, tech layoffs, and cryptocurrency failures, analysts rushed to bring down future earnings estimates. Overwhelmingly negative consensus expectations sharply lowered the bar going into 2023.

Second, though not uniformly robust, earnings results for many growth companies have proven to be surprisingly resilient. Pockets of strength were found within medical devices, semiconductors, automation, and software. Management teams have voiced the need to operate efficiently in an inflationary environment. For many, innovation and disruptive technologies have played a key role in meeting this objective and will likely continue to do so. Moreover, resilient demand supported the revenues of many of these disruptive growth companies. Their standout performance has led to high dispersion in financial results, creating a healthy backdrop for fundamentally driven stock selection.

Finally, while this may seem counterintuitive, many growth stocks are actually benefiting from a weakening economy. The potential for a broad “earnings recession” has prompted investors to take a fresh look at the outlook of growth companies generating quality earnings supported by strong secular drivers. Amid cyclical weakness, the fundamental momentum of such companies has sparked rising investor confidence in their prospects, supporting a scarcity premium for high-quality growth stocks similar to that seen in prior episodes of economic weakness. Although not obvious to investors fixated on macroeconomic headlines, we think this presents a favorable setup for growth stocks capable of earning their way through a difficult period, well positioned to expand like coiled springs into the next recovery.



For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

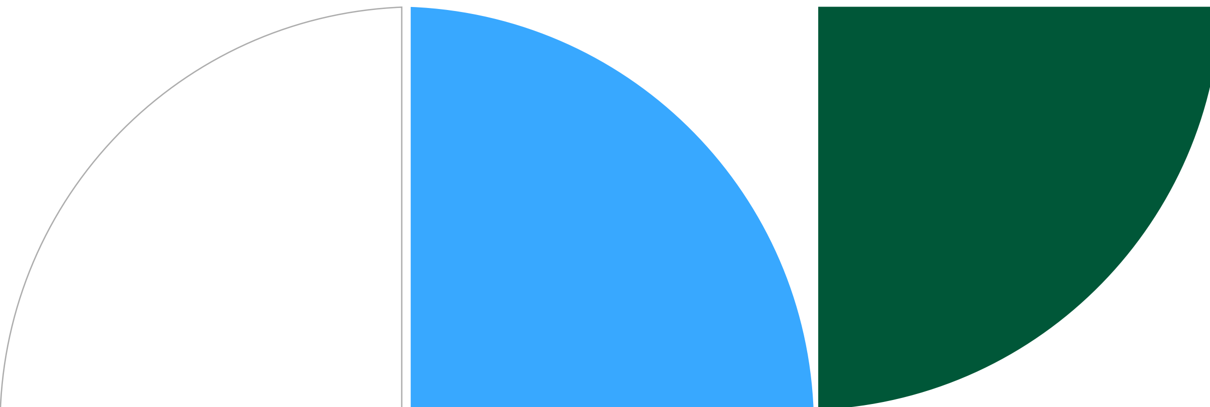
Contact details

FOR U.S. INVESTORS ONLY

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at **AllspringInstitutional@allspringglobal.com**.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at **1-888-877-9275**.
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Retirement, at **nathaniel.s.miles@allspringglobal.com**.
- To discuss sustainable investing solutions, contact Henrietta Pacquement, head of Sustainability, and Jamie Newton, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

FOR NON-U.S. INVESTORS ONLY

- To reach our non-U.S.-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.



CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

Source: Standard & Poor's 500 Index (S&P 500 Index) consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

The FTSE NAREIT All Equity REITs Index is a free-float-adjusted, market-capitalization-weighted index of U.S. equity REITs. Constituents of the Index include all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property. You cannot invest directly in an index.

This information is a marketing communication, unless stated otherwise, for professional, institutional, or qualified clients/investors (as defined by the local regulation in the respective jurisdiction).

Not for retail use.

This material is provided for informational purposes only and is for professional, institutional, or qualified clients/investors. Not for retail use outside the U.S. THIS MATERIAL DOES NOT CONSTITUTE AN OFFER OR SOLICITATION AND IN ANY CASE IS NOT INTENDED TO BE USED IN ANY JURISDICTION OR TO ANY PERSON WHERE IT WOULD BE UNAUTHORIZED OR UNLAWFUL TO DO SO. Allspring Global Investments™ (Allspring) is the trade name for the asset management companies of Allspring Global Investments Holdings, LLC, a holding company indirectly owned by certain private funds of GTCR LLC and Reverence Capital Partners, L.P. Unless otherwise stated, Allspring is the source of all data (which is current or as of the date stated); **past performance is not a guarantee or reliable indicator of future results**; all investments contain risk; content is provided for informational purposes only with no representation regarding its adequacy, accuracy, or completeness and should not be relied upon; views, opinions, assumptions, or estimates are not necessarily that of Allspring and are subject to change without notice; and this communication does not contain investment advice, an investment recommendation, or investment research, as defined under local regulation of the respective jurisdiction.

FOR PROFESSIONAL INVESTOR USE ONLY OUTSIDE OF THE U.S.

© 2023 Allspring Global Investments Holdings, LLC. All rights reserved.