

## **Exchanges at Goldman Sachs**

### **Should investors stay invested in 2023?**

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**Allison Nathan:** By almost all accounts, 2022 was a difficult year for investors' portfolios. While 2023 seems to have started out on a somewhat more positive note, the road ahead looks foggy and uncertain. So, should investors stay invested in the markets?

**Sharmin Mossavar-Rahmani:** We are recommending clients stay invested. And that theme of staying invested applies much more to US equities than, let's say, emerging market equities.

**Allison Nathan:** I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

**Allison Nathan:** Today I have the great pleasure of

speaking with my colleague Sharmin Mossavar-Rahmani who is the head of the Investment Strategy group, ISG, within GS Asset & Wealth Management and the chief investment officer of GS Wealth Management.

Sharmin recently published her 15th annual outlook titled "Caution: Heavy Fog" which outlines her team's investment themes and recommendations for clients for the year ahead.

Sharmin, welcome back to the program.

**Sharmin Mossavar-Rahmani:** Hello, Allison. Thanks for having me on.

**Allison Nathan:** I always look forward to this conversation. So, let's get started. 2023, as I said, looks to be off to a pretty strong start for the markets. But we're still facing many economic and financial market uncertainties, including the risk that the Fed over tightens or, arguably, has already over tightened and creates a recession in the US. You're assigning a 45 to 55 percent probability to the risk of a US recession this year. That's the highest range from ISG in a decade. So, what's behind that view?

**Sharmin Mossavar-Rahmani:** Allison, this could not have been a better day to have this conversation because we just had the nonfarm payroll release the unemployment data out there. And it was a very high number. And a surprisingly high number.

So, even though our colleagues in Global Investment Research and the Economics team had an above consensus number, the 500,000 plus number that was printed in terms of the employment figure is unexpectedly high. And this is a time where people would say, oh, the Fed has to tighten much further than the market has priced in. And so, the odds of a recession must have gone up.

And then you look at a year like the first part of this year, January, and you said the year is off to a great start. And one says, wow, the equity market is up so much. Rates have come down. Financial conditions have eased. So, the probability of a recession goes down.

So, we are trying to convey to clients that there is a lot of uncertainty out there. We have a much wider range than usual. We do not usually, and never have had a 10

percentage point range in our probability of a recession. So, we have 45 to 55.

The reason we have a wide range and it's somewhere right in the middle where it's a 50/50 toss up whether we get a recession or not is because we want clients to know they should not position a portfolio for the certainty of a recession or for the certainty of no recession. We just think there's so much uncertainty. People should be at a very good strategic asset allocation that is customized for them. And just stay there for now. Because the market's going to swing around.

Who would have thought in January that we would get a 6 percent total return on the S&P? It was just unusually high. And if people had chosen to be underweight because they were worried about recession, they would have missed that. On the other hand, if they were overweight, maybe today's not going to be such a great day for them.

So, I think people just need to understand there is, as our title suggests, a lot of fog out there.

**Allison Nathan:** But just to clarify, because on this

podcast you recently spoke with Jan Hatzius. You know him well, our chief economist, our head of Global Investment Research that you mentioned. And for a long time now, he's been calling for a soft landing. So, just for our listeners, can you just describe a little bit the difference between you and Jan?

**Sharmin Mossavar-Rahmani:** We work closely with Jan and his team. David Mericle is our US economist in Global Investment Research. And we always make a point of knowing what their views are and what drives their views. And in fact, some of the work that the team has done, like the work David Mericle has done, on the highest impact of the tightening of financial conditions on GDP and when it occurs is one of the arguments we have for why the probability of recession is lower. So, why it's 45 percent. And then we look at other factors and say, no, that points to 55.

So, we definitely work very closely with Jan and his team. But we think there's just greater uncertainty out there. And we look at other economists, other people we respect a lot. And until recently, literally a few days ago, Bill Dudley who's a former colleague and was head of the Federal

Reserve Bank of New York and a vice chair on the FOMC, so a policymaker as well, tremendous experience, and a colleague of Jan's for seven years, one was at 70. And Bill Dudley just went down to 60. And Jan was at 35.

So, there is evidence of two incredibly thoughtful, well trained economists who worked together. And one has one of the lowest probabilities. And one had one of the highest probabilities. Now, he's lowered his probability to 60. But it's still quite high.

And our view is when you look at that, it tells you that there is so much uncertainty. And then chair Powell in his December conference said nobody knows if we're going to have a recession. And we actually think that is correct.

And so, we know why we have the differences. We think it's important to look out and see what other people's views are. We like to incorporate it into our thinking. But that has just made us more uncertain rather than more certain.

**Allison Nathan:** And just to clarify again, the Investment Strategy Group needs to understand the macro backdrop because you're advising private wealth clients on how to

allocate their portfolios based on that view. You have a very specific mandate in that sense.

**Sharmin Mossavar-Rahmani:** Exactly. Our job is not to have economic views. We talk to a lot of other people. We may have economists on our own team, which we do. But at the end of the day, it's a means to an investment recommendation. That's the ultimate goal.

**Allison Nathan:** Let's talk a little bit about inflation. Because that is such a big part of what we expect to come for the coming year. And people will look at that payroll's number and think wage inflation is not going to let up. There's a general consensus that inflation has peaked. And it'd be interesting to know if you share that view and how much conviction you have in that view.

**Sharmin Mossavar-Rahmani:** That's actually a great question because that's an area where we do have conviction that inflation has peaked. I don't think there's much disagreement in our industry in that view. And some of the agreement is on some specific sectors where inflation has been higher.

So, I think everybody agrees that inflation in core goods has been coming down and will steadily continue to decrease. I think there's general agreement that housing is going to come down. And we've seen the data, current data, whether it's through home prices or through current rental rates, we see that pace of inflation coming down as well.

So, the biggest question mark out there is an issue of where will wages go. And if you look at some of the more current data that you can get, like surveys and job postings and what wages are put there, you would see them coming down. But the key question is, are they coming down at a strong enough pace to prevent any further tightening beyond what most people think?

So, Jan Hatzius and our group as well think the Fed gets to 5 - 5.25. And maybe they pause to see the full impact of that. But if we have a few more of these nonfarm payroll numbers like we got today, they obviously will end up going further.

So, the biggest certainty is around core goods and housing. The biggest uncertainty from our perspective is around wages.



**Allison Nathan:** If we stick with the recession question for one more moment, if we are going to see a recession, when do you think it's most likely to appear? Later this year? 2024? Do you have a view?

**Sharmin Mossavar-Rahmani:** We have a yield curve diffusion index. It looks at a lot of different yield curves. And when we see this yield curve inversion diffusion index trigger, we've generally had a recession. So, it has triggered. It triggered last summer of 2022. And typically, when you look at when a recession happens, it either happens within a few quarters, or it happens about two years out. So, it's not a good indicator of when the recession will happen. It just gives you a distribution. So, it doesn't tell us a recession is definitely more likely in one year.

But what we know is it's unlikely that we're going to get a recession in the shorter period. So, if you look at the distribution of the impact of the signal, it is, okay, next two quarters. But we're obviously not going to get a recession with nonfarm payroll numbers and the momentum that we had from the second half of 2022. So, it's unlikely that we get anything near-term. It's more likely, especially if the

Fed has to continue to tightening, we get something either later in the year or in 2024.

And that matters because if we were to have a recession sooner, by the end of the year, the market will be looking towards earnings in 2024. And we could have pretty good returns. But if the recession were to happen towards the second half or let's say even the fourth quarter of 2023 or people are anticipating it for 2024, that would not be good for the equity markets.

So, again, we're watching that. But our base case is that the equity markets will do generally well. That with nominal growth, S&P 500 companies will generate reasonable nominal earnings. We expect earnings growth about 4 to 6 percent. And our base case return for 2023 is about 13 percent total return. Obviously, we got a fair amount of that in January.

**Allison Nathan:** I want to talk more about your market views. But before you do that, let's stick with the macro for a moment because even though our conversation has been mostly about the US, of course one of the biggest surprises heading into late last year into early this year has been

China's lifting of COVID restrictions, which of course, I think, came a lot faster and earlier than many people anticipated. And is clearly going to have some implications for global growth this year.

So, what are your views on China over the near term and medium term given that big swing in policy?

**Sharmin Mossavar-Rahmani:** Our view is that China will grow above trend. So, the big question is what is trend in China? And we think trend in China is 4 to 4.5 percent. And so, maybe China grows closer to 5 for some short period of time.

But we think the current euphoria that everyone feels about China is not going to last long. We just published a report on China called "Middle Kingdom, Middle Income." And we talk about the various headwinds to China. Some of them domestic, and some of them external to China.

The domestic ones would be things like demographics. China is facing the same demographics that Japan faced in 1990. And declining demographics and a declining labor force is never good for growth. So, our view is over the next

ten years, for example, China will grow at half the rate that it did before COVID. So, before 2020, China was growing, let's say, about 7.5 - 7.7 percent annualized over the prior ten years. We think that number going forward is going to be, the average number, will be 3.4 percent. So, it's a pretty significant decline.

So, while there might be some euphoria now with the opening of China, our view is that it's not going to be long lasting. And in fact, companies, countries need to think about their policies if they're major exporters to China. They need to think about the long term.

And obviously, we just got earnings from a few companies. And they talked about the impact last year of the slowdown in China. So, it does affect US companies, European companies, European luxury goods companies, iron ore exporters. So, we encourage our clients to just think about that in terms of how they think about where assets should be allocated.

**Allison Nathan:** But you have upgraded the 2023 expectations even though you're concerned about the medium term?

**Sharmin Mossavar-Rahmani:** Yes, exactly.

**Allison Nathan:** And longer term. Okay. And what about Europe? I think we were all forecasting a recession in Europe, which looks less likely at this point. So, where are your views on Europe at this point?

**Sharmin Mossavar-Rahmani:** We actually followed the lead from GIR, our colleagues in Global Investment Research when they changed their forecast from a recession to avoiding a recession. And that's basically driven by much better weather. So, that's obviously something we cannot forecast. And by being able to fill the storage with natural gas much faster than they thought. It's really been phenomenal that Germany's been able to build a regasification plant in less than a year. And now US is one of the largest exporters.

And when there's a particular plant in Texas that's going to come back on stream, it's expected to be the largest exporter of liquefied natural gas. So, it's just phenomenal. So, the energy picture is certainly changing in Europe quite significantly. And they've shown more resilience.

But there you do see the ECB being quite aggressive about fighting inflation. And so, maybe it's going to be modest growth. It's not going to be surprisingly strong growth. And, obviously, there has to be a significant risk premium given what's going on in Ukraine and Russia.

**Allison Nathan:** So, we started to talk a little bit about your market views. For years, you've maintained your recommendation that clients should stay invested because the gains you might miss out on if you're underinvested because you're worried about short-term declines are just not worth it. So, given that we've had such a strong January, do you think clients should stay invested at this point?

**Sharmin Mossavar-Rahmani:** Given the uncertainty that is out there, yes, we are recommending clients stay invested. And that theme of staying invested applies much more to US equities than, let's say, emerging market equities. So, we actually have a very low allocation to emerging market equities and would not recommend clients have significant allocations and stay invested in that asset class.

But when it comes to US equities, for example, we do say stay invested. And the key underlying rationale behind that investment recommendation is that more often than not the US economy grows. Right? So, at times you see a recession depending on how far back in history you want to go is in the mid teens. So, you have a recession, let's say, 15 to 17 percent of the time. That means the rest of the time, the vast majority of the time, you're in economic expansion. That generates earnings. The price generally follows the path of earnings. Not short term, but long term.

And so, by going underweight, you're fighting an upward trend. So, unless one happens to have a crystal ball, and we don't think anybody in our industry does have a crystal ball, then by trying to get in and out of the market, you can actually lose a lot of value, let alone if people are taxpayers.

**Allison Nathan:** But at least for 2023 when we think about the better growth outlook for Europe and European equities have performed quite well heading into the year off the back of that, China, it might be short lived, but we are seeing more growth there than we had anticipated and a lot of reasons that that momentum will stay for at least a few

quarters. Near term, do you think that US preeminence might fade to the background, at least in 2023?

**Sharmin Mossavar-Rahmani:** In the report, the outlook that you mentioned earlier, Allison, we actually have a few pages dedicated to this US preeminence theme. And again, that report is available on GS.com for anybody who'd like to look at the exhibits. It's about 16 exhibits that underlie our view of why US preeminence exists. And it's not a short-term view.

So, for example, we talk about labor productivity. It's just an amazing surprise to some of our clients when they see that exhibit that looks at labor productivity in the US versus all these other countries, advanced economies as well as some of the emerging market economies. There's a ranking, for example, for corporate management. The quality of corporate management in the US relative to others. And the initial study was done by non-Americans. They were English and other Europeans. And they make a point of saying that to show they don't have any bias towards the US when they say US corporate management gets the highest rank.



You can look at general levels of human capital. You can look at levels of innovation. All of those point towards US preeminence. So, it's not a short-term view.

**Allison Nathan:** And if we think a bit about the construction of portfolios, the 60/40 portfolio that we're all used to hearing about had undeniably an awful year in 2022. If you look ahead to this year and beyond, do you think that the underlying concept of a 60/40 portfolio needs to be questioned? Or was that just an anomaly last year?

**Sharmin Mossavar-Rahmani:** Allison, you are raising one of the very interesting questions that clients are asking us about. And I'm actually not sure why it has become such a topic of interest. I think partly because of last year when you had both stocks and bonds go down in the US, obviously that was not the case everywhere in the world. For example, in the UK, equities were actually marginally up last year because of the heavy allocation to the energy sector in their index, while the US has a lot more allocation to technology. So, no doubt, in the US it was a very unusual year.

Having both stocks and bonds down only occurs 2 percent of the time since 1926. So, it's very rare. So, we can understand why people ask the question. After about two decades correlations between stocks and bonds went back up to being positive, and people were saying does that mean the 60/40 actually is no longer valid. And our point is, first of all, nobody's exactly at 60/40. And I don't mean the stock/bond allocation, but the view of just owning stocks and bonds. Most people want to have more diversified portfolios. Diversified in terms of looking at high yield, whether it's corporate high yield or municipal high yield bonds. Where it is US versus non-US equities. And then for those who have slightly larger portfolios, being able to invest in alternatives like private equity, buy outs, growth equity, private credit, real estate, infrastructure.

So, we do think that a stock/bond portfolio as a reference point is still a great starting point. But then we recommend clients look a lot at the strategic asset allocation. Use diversification. And we try to build customized models for our clients that have better diversification. So, our view is that having a stock/bond benchmark, whether 60/40, 50/50 depending on their risk tolerance is still a great point as a starting point from which to determine client

strategic asset allocation.

And typically after such a big down period, the next 12 months and next 24 months are actually incredibly attractive. So, one wants to stay invested given that one's already experienced the down draft to capture the upside.

**Allison Nathan:** And is there an asset class that looks particularly undervalued to you right now that you would want to more heavily overweight?

**Sharmin Mossavar-Rahmani:** There are tactical opportunities more in sub asset classes. So, for example, when you asked the question, we actually just reduced our exposure. We've had a tactical tilt towards Eurozone banks for a very long time. But they were up so much in January that we actually eliminated that exposure.

We had a slight overweight to US equities through coal options. And again, with the market rallying so much, we took that tactical tilt off. So, right now when we're looking at asset classes, we don't see huge opportunities to overweight or underweight any sector in the US or any particular country broadly. We still have a couple of small

tactical tilts towards the energy sector in Europe and in the US. But those are small allocations.

What's interesting is people are asking us is this a good time to be going overweight Europe and emerging markets because they appear so much cheaper. And we say it is correct based on valuations they appear much cheaper. But if you actually adjust the sector allocation, and make the sector allocation of each of these market indexes to match the sector allocation of the US, they suddenly don't look so cheap.

Maybe, for example, China goes from appearing to be 35 percent cheap, to maybe 10 percent cheap. But does that 10 percent really give you enough of a discount for all the risks that we believe China faces? And the answer for us is no.

**Allison Nathan:** Let's talk a little more about risk broadly. We've talked about the risk of recession. We've talked about the risk of uncertainty. But what risks are you most focused on as you look into 2023?

**Sharmin Mossavar-Rahmani:** Obviously, the biggest risks

are the risks of recession and of inflation not coming down at enough of a steady pace so that the Fed or the ECB or Bank of England don't tighten so much that they create a global recession. So, those are the ones we're most vigilant about.

Then we worry about geopolitical risks. Obviously, there's a large, long list of geopolitical risks to worry about. So, we start with, obviously, any escalation from Russia in terms of the Russia-Ukraine War. And President Putin keeps on dropping hints about plans to escalate. So, that's something to worry about.

But it doesn't mean we should get out of equities because maybe it's a threat, maybe it isn't. And these political shocks, these exogenous shocks are hard to anticipate and plan for. For example, increased tensions between US and China. And again, we got the report just a couple of days ago about this balloon that the US intelligence services, the military all say is a spying balloon from China. So, here's just one more example on China being a little bit more aggressive in its foreign policy. And we talk a lot about that in the report.

So, for people who'd like to see and understand how we think about the risks from China, that's a second big category that we worry about. But then we also are aware about North Korea and their constant ballistic missile testing and whether they'll actually test any nuclear missiles. We worry about escalation in Iran, whether it's their enrichment or whether it's their relationship with Russia.

Cyber security, risk of terrorism, and of course, most importantly, domestically the debt ceiling. And our colleagues in GIR have done a lot of work on that. And we know that with a policy in Washington, we're going to have a lot of market volatility. So, that's also one to watch. But it's not clear what one should do about that. Do you actually get out of treasury bills that mature in that period? Or do you just say there's going to be interim volatility. The US is not going to actually default on its coupon payments and bond maturity payments, and one should just ride out that volatility. Now, is there a zero risk of problems? Of course, not with the debt ceiling. So, a lot to worry about, for sure.

**Allison Nathan:** Let me end with a question, this is

always my favorite question, about the cover of your report, which you put a lot of thought into. So, tell us a little bit about why you chose that image and the message you intend to convey.

**Sharmin Mossavar-Rahmani:** Allison, as we always try to make sure that clients can just look at the cover and the message is conveyed, as you say. And basically, the cover this year, the title is "Caution: Heavy Fog." So, clients get a sense of the uncertainty. The image is heavy fog. And then we have all these road signs. And the road signs are all messages which are described in detail in the report on what to do and what not to do as they think about going through 2023.

So, for example, we recommend don't make fast lane changes. Just like in a heavy fog, you wouldn't move around, you just stick to your lane and go very slowly, the message is don't move the portfolio around. Don't try to underweight and overweight tactically because you can actually just end up losing money and not making any money and having an accident if you're in a real fog.

We say watch for hazards. The risks that you asked about

earlier would be among the hazards. So, we're watching for them. We're vigilant. But it's not clear with these low probability events, should we actually move the portfolio around? We say be vigilant, pay attention. So, that's what we're doing with the inflation and with nonfarm payroll numbers.

So, we have road signs for clients to think about what are the issues to consider as we go through 2023.

**Allison Nathan:** Thank you so much for joining us, Sharmin. It's always so insightful.

**Sharmin Mossavar-Rahmani:** Thank you very much for having me.

**Allison Nathan:** Thanks for joining us for another episode of Exchanges at Goldman Sachs recorded on Friday, February 3rd, 2023.

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