Never stop learning

A midyear update from Allspring's chief investment officers

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As 2023 matures, the global economy is slowing and the risks of recession are rising. Witnessing the contraction phase of an economic cycle is nothing new for seasoned investors—there have been six recessions in the U.S. since 1980, and each has had unique circumstances that investors can try to pull from today. We have to go back to the 1970s and early 1980s for some clues on interpreting today's inflationary environment, which is admittedly a period that few of today's professional investors managed through.

The return of inflation after such a long absence adds a degree of difficulty in interpreting reported gross domestic product (GDP) growth. Nominal growth remains robust, but "real" growth is weak—the difference attributable to meaningful levels of inflation. Hidden in plain sight, the real growth slowdown is difficult for many market participants to recognize, and it will take some time to fully manifest in market expectations. We think we are living through a period of "slowflation," which, to date, is a less severe form of the stagflation (zero growth, high inflation) that existed in the 1970s.

Another circumstance of today's economic slowdown is stress in the global banking system. We can look to the Global Financial Crisis in 2008–2009 for clues. Back then, cheap financing and subsidies inflated a residential real estate bubble built on poor underwriting standards. Banks originated, repackaged, and sold loans as complex derivatives and structured products until the financial system was saturated with housing exposure. When interest rates rose to throttle the excesses, markets learned very quickly that housing prices can in fact fall. Banks with the most exposure to housing were hit first, and then the damage spread to the broader financial system in history's biggest margin call to date.

Nearly 15 years later, monetary stimulus has reinflated real estate values, but the excesses are taking a slightly different form. Today's high vacancy rates in office buildings and the shuttering of retail outlets are hitting regional banks that specialize in commercial real estate lending, and rapidly rising interest rates are also hitting banks' broader loan and securities portfolios. Meanwhile, high short-term rates are luring low-yielding bank deposits into much-higher-yielding money market accounts. We can think of deposit flight—really an old-fashioned bank run—as another form of margin call. The point of this story is that the characters may be different, but the plotline is very similar and can be anticipated.

The speed of some of today's bank runs is remarkable. Consider that in 2008, Washington Mutual lost $17 billion of deposits in nine days. Earlier this year, Silicon Valley Bank saw $42 billion withdrawn in just four hours! Our investment research led us to higher-quality names and limited our exposure to recent bank failures across fundamental strategies. Underweights to regional banks and short exposures to some failing banks have benefited systematic strategies. However, the speed of deposit flight has been a surprise, and we are accounting for this new reality in our evaluation of risk in the banking sector going forward. We never stop learning.

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Looking ahead

Mark Twain once said that history never repeats itself, but it does often rhyme. Maybe markets were his inspiration. There are always new circumstances that challenge the perfect analogue to past experiences. But the rhyming part gives us a road map for how to get the big decisions right. Below are broad brushstrokes that can guide investors for the balance of 2023.

01 **Income:** In the recent past, investors could rely on broad economic growth and suppressed interest rates to drive capital gains, but that market phase has likely passed. History shows us that to pursue portfolio growth today, investors must lean more heavily on dividends, coupons, and cash income. An income focus can be made in traditional equity and bond markets as well as in multi-asset and derivatives strategies that combine investment capabilities. Income can augment total returns and buffer capital losses.

02 **Quality:** First-quarter earnings season showed us that companies with strong balance sheets, ample free cash flows, and largely self-funded operations were rewarded by markets. For example, many larger banks have held up better than others due to their broader asset and depositor bases that support more stable net interest margins. Quality fundamentals also support the sustainability of income, whether in the form of dividends or scheduled fixed income payments.

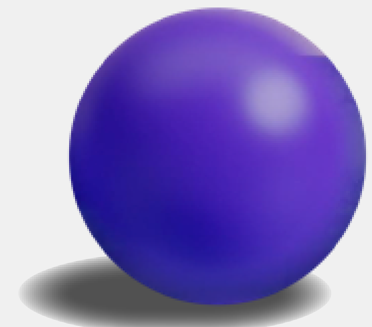
03 **Active management:** The past teaches us that dispersion in the performance of individual securities increases in periods of market stress. The ability to differentiate winners from losers through fundamental and quantitative methods can provide opportunities for selection alpha. More broadly, the ability to under- and overweight sectors, or the ability to be outright short, can support the pursuit of allocation alpha. In fixed income markets in particular, the inverted yield curve in the first half of 2023 provided a great opportunity to take advantage of higher short-term rates. The pace of monetary tightening should moderate with a slowing economy in the second half of the year. As the yield curve steepens, this will provide an opportunity to rotate to longer-duration assets.

04 **Diversification:** Within portfolios and across asset classes, the benefits of diversification are back on center stage. We were a bit surprised by the strength of the information technology rally in January, and we have generally favored defensive positioning in this environment. Investors appear to be anticipating a pivot by central banks toward more accommodative policy, even on days we would have expected defensives to outperform handily. This heightens our need to manage exposure to changes in interest rate expectations across all asset classes and risk premia. Portfolios need to be reassessed using multiple risk lenses to identify where weakness may be hidden. This only serves to highlight the valuable role that diversification plays in managing uncertainty and mitigating the cost of making mistakes—we've learned that those are inevitable for even the most seasoned investors.

Later in this report, we've asked senior members of our investment teams to comment on their respective areas of expertise. We think you will find echoes of the above themes in their contributions. For now, we encourage you to remain patient and balanced in your posture toward accepting risk in your broader portfolios. Don't stop believing, and never stop learning.

Thank you for the honor and privilege of managing your capital.

Sincerely,



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

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