Global equity markets ended higher after another volatile quarter. The MSCI* All Country World Index (ACWI) increased 9.8% over the fourth quarter, with the benchmark experiencing an early double-digit rally through mid-December before fading a bit into year-end. The global index finished down 18.4% for the year (all returns stated in US-dollar terms), a significant reset after several years of healthy gains. The cumulative effect of higher interest rates on the global economy suggests a continued difficult backdrop for earnings and stocks as we enter the new year.

The Fight Against Inflation May Linger Longer than Hoped

The root cause of market weakness in 2022 was interest-rate hikes spurred by widespread and accelerating inflation. Hence, one of the key focuses for investors heading into 2023 is the outlook for inflation and how central banks will address it.

The trouble with inflation is that it's more than a single number, so while some prices have already fallen, others remain elevated. So-called headline CPI in the US, for example, peaked at 9.1% in June and registered 7.1% in November. Under the surface, while goods inflation has fallen dramatically, services prices remain stubbornly high. And labor markets remain tight, causing wage inflation to remain sticky. Full employment in the broader economy may give the US Federal Reserve and other central banks latitude to keep the pressure on financial markets.

For its part, the Fed has consistently reiterated its resolve in fighting systemic inflation. The minutes from the Federal Open Market Committee meeting in December warned investors that "an unwarranted easing in financial conditions…would complicate the committee's effort to restore price stability." Fed Chair Powell is a fan of Paul Volker, who is famous for his aggressive action in the 1970s to bring inflation under control. Investors would be wise to remember the precedent set by the latter.

Higher Interest Rates Cause Corporate Earnings Pain…with a Lag

Global central banks have already done a lot of heavy lifting when it comes to reigning in financial conditions. Central banks overseeing the 10 most heavily traded currencies raised rates 54 times in 2022—the largest and quickest advance in the last two decades. US federal funds, for example, rose from 0.1% to 4.4%, the largest annual move since 1973. Emerging-market central banks raised rates 93 times, though they are likely closer to the end of their tightening cycles relative to developed-market counterparts.

We're already starting to see evidence that global economic growth is stalling. Housing markets, most notably, have been weak across the globe. The US Purchasing Managers' Index fell for the second straight month in December, and its 10-point drop in 2022 was the biggest annual retreat since the Great Recession. Separately, the Federal Reserve Bank of St. Louis stated in a recent report that if 26 states have falling activity within their borders, it offers "reasonable confidence" that the nation as a whole will fall into a recession. As of October, 27 states were seeing contraction.

We are mindful, however, that interest rates impact the real economy with a substantial lag—typically one to two years. The full effects of 2022's historic tightening, therefore, are still likely in front of us, not behind us. A key risk for markets is that this potential weakness is

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*MSCI indices measure the performance of different stock types in geographic areas. They track the performance of the stocks included in the index and are used as the base for exchange-traded funds.

not yet reflected in corporate earnings forecasts. The consensus, despite mounting evidence that would historically suggest otherwise, expects more of a Goldilocks scenario, where central banks tame inflation but do not impair growth. We're not so sure.

For 2023, the consensus continues to believe that earnings will grow roughly 4.5% with current expectations for 2023 S&P 500† earnings of about US$230 (source: Strategas Research Partners). In recessionary times, it's not uncommon for earnings to fall by more than 10%, which would equate to S&P 500 earnings well below US$200.

And markets are still not cheap in an absolute sense, so if earnings do in fact decline to start the year, markets are likely to follow, at least in the near term.

The Case for Optimism

There is a case for higher equity prices by the end of 2023, however, and it rests, in part, on the amount of pain that has already been felt by investors. Global stocks and bonds lost investors more than US$35 trillion in value in 2022. Since 1928, the S&P 500 has only fallen for two straight years on four occasions: the Great Depression, World War II, the 1970s oil crisis and the bursting of the dot-com bubble. So, to bet on another down year for the markets would be taking the long odds.

Markets are forward-looking mechanisms, and once the extent of the earnings hit is priced in, investors may start looking to the other side of rate hikes, peaking inflation and improved supply chain dynamics. Additionally, China's decision to remove COVID-19 controls has caused infections to rise dramatically, but it also brings the prospect of natural herd immunity sooner than otherwise would have been the case. If this more bullish scenario plays out, equities and bonds could put more money in investors' pockets in the near future.

Portfolio Performance

For the fourth quarter, Class A shares of the AB Sustainable Global Thematic Portfolio increased in absolute terms and outperformed their Benchmark, the MSCI ACWI, net of fees and in US-dollar terms. For the year, shares of the Portfolio posted negative absolute returns and underperformed their Benchmark. The MSCI ACWI returned 9.8% for the quarter and –18.4% for the year. Value stocks outperformed growth stocks. Quality fundamentals outperformed, continuing the reversal and taking back more of the ground lost in the first quarter's historically sharp low-quality value rally.

Flex, from our Climate theme, is a manufacturer of products that enable connectivity, safety and innovation for societies around the world through programs that involve waste reduction, product reuse and overall environmental sustainability. The company contributed, as its earnings stream is proving to be more resilient than feared, driven by increased outsource manufacturing globally and new program ramps in several key markets.

Deere & Co., from our Health theme, provides precision agriculture equipment and technology to enable higher crop yields and reduce the amount of fertilizer used. The company contributed after a very strong set of quarterly results and a better-than-expected outlook for 2023. The velocity at which order books are being filled remained very strong in the quarter, with order books now being extended into the second half of 2023. While margins are expected to normalize a bit from elevated pricing, industry demand remains robust across regions, led by North America.

Erste Group Bank, from our Empowerment theme, is one of the largest financial services providers in Central and Eastern Europe, engaging in microfinancing and social banking initiatives aimed at the financial inclusion of underrepresented groups that are often excluded. The company contributed on the back of robust results and a strong 2023 outlook. Erste maintains a solid buffer against any looming recession risk or adverse impact from Russia's invasion of Ukraine and is positioned well for the year to come.

Lumentum Holdings, from our Empowerment theme, is a leading optical component supplier that enables access to digital information, helping to create platforms for commerce and the empowerment of individuals and small and medium-size businesses. The company

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†The S&P 500 is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

detracted as supply constraints continued to impede its ability to deliver product to telecommunications customers. Lumentum also saw a pause in spending at a leading web-scale firm and lower demand from Apple for its 3D sensing chips amid weaker consumer spending.

SVB Financial, from our Empowerment theme, operates one of the only banks in the world that provides financial services to the "global innovation market." As such, it provides capital to private equity/venture capital firms and start-ups, particularly in the technology and healthcare/life-sciences sectors. The company detracted, as start-ups continue to spend down cash, weighing on SVB's deposit base. However, there is a significant amount of cash in the industry, estimated at US$3 trillion, which should help to offset any slowdown as investors look to enter at lower valuations.

Waste Management Inc., from our Climate theme, provides waste collection, recycling and disposal services that help customers reduce pollution and waste production, and improve resource circularity. The company detracted as management lowered 2022 and 2023 free-cash-flow guidance by an estimated 5%, driven by higher green-project capital spending, interest expenses and taxes. While higher spending is a modest near-term headwind to free cash flow, the benefits include strong projected returns and higher long-term earnings power. We continue to like the name based on its resilient, secular growth; strong pricing power; ability to take market share and outgrow the recycling/waste collection market; and attractive valuation.

Outlook: Sustainable Themes Offer Growth and Resilience

Economic growth is slowing, and our base case forecasts a higher frequency of negative earnings revisions for 2023. Companies with stronger fundamentals and higher-quality attributes such as low debt levels and higher returns typically perform best during such periods. Our approach favors companies with higher quality and growth attributes, though we've recently emphasized more of the former at the expense of the latter as we prepare for a volatile start to the year and potentially more pressure on equities.

Our focus as thematic investors is finding private sector solutions to the world's biggest challenges. Broad shifts in the global economy take years to run their course, and global challenges such as climate mitigation, access to healthcare and infrastructure needs are not solved overnight. Importantly, companies providing solutions to these persistent and growing challenges should experience more resilient demand for their products and services than those that are reliant upon cyclical demand, in our view. We expect this to translate into more resilient earnings, which may hold increasing appeal to investors if earnings growth becomes more scarce.

As always, thank you for your continued support,

Dan Roarty

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A full explanation of the risks is provided in the Portfolio's Prospectus.

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