COLUMBIA THREADNEEDLE INVESTMENTS

Global CIO Q&A: on inflation, rates, recession and more

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Inflation has reached record levels. What do you expect in the upcoming months?
High and rising inflation in Europe and the US has been fuelled by several factors so far this year, as continued supply chain issues have been compounded by increasing food and energy prices, particularly in the UK and Europe where the volume of imports is higher. Central banks had appeared to look through these pressures but as inflation has persisted, restrictive monetary policy seems to be the preferred approach to attempt to bring it to a more acceptable level. We would expect inflation to remain elevated for the remainder of the year but should fall in 2023.

What levels might interest rates reach in the UK, Europe and the US?
We expect interest rates will rise further in all those regions, reaching around 4.25% in the US and 1.75% in Europe by the end of this year. However, as the economic slowdown and likely recession takes hold, we would anticipate rates will plateau in 2023. Given the recent change in fiscal policy in the UK, rates here are more difficult to call, but we would expect further rate rises this year, possibly to 3.75%.

The risk of a recession is becoming more concrete. Have markets already discounted it?
The US has experienced two quarters of negative economic growth this year and the probability of the US and Europe entering a recession by the end of the year is high. Markets have priced in some fiscal tightening from central banks, although the initial hike from the European Central Bank was larger than expected at 50bps[1]. The concern is how deep the recession will be, how long it could last and what it will take to bring inflation down to a more acceptable level. More recently, there have been some nascent signs of wage growth as inflation expectations have picked up markedly and policy makers will be keen to avoid high levels of wage inflation.

[1] CNBC, ECB surprises markets with larger-than-expected rate hike, its first in 11 years, 21 July 2022

The UK faces a harsh outlook as a result of recent policy changes by the new government leaders. Although officially UK GDP was positive through Q2 of this year – defying most expectations – the tax cuts and fiscal measures announced in the mini budget did little to assuage consumer confidence and cost of living fears, even though the former was ultimately reversed. Furthermore, the decline of sterling and the sharp rise in bond yields is likely to drag on the British economy through the remainder of the year.

How do emerging countries fit into this picture?

The geopolitical environment of 2022 has added volatility to markets globally. In addition to the economic growth constraints seen in Europe and the US, emerging market (EM) countries are also faced with external challenges to growth, such as the US Federal Reserve's hiking cycle; a stronger US dollar; high commodity prices, which hurts food and energy importers; and a weaker China. China's stimulus has not yet translated into positive growth spill overs and the zero-Covid policy causing frequent and far-reaching lockdowns delays an improvement in the economic growth picture. These factors contribute to a risk-off environment, make existing dollar-denominated debt more expensive to service, and limit market access for high-yield emerging market issuers. However, external reserve buffers are stronger than in previous market downturns which allows EM countries to fund some of their own balance of payments gaps.

Which sectors should you focus on at this stage?

At Columbia Threadneedle Investments we are long-term investors with a preference for quality growth companies with strong balance sheets. Given the current volatility and broader economic backdrop, we look for companies with pricing power that will withstand sustained, high inflation and will be less impacted by reduced consumer spending and higher interest rates.

Energy as a sector has outperformed through recent months, but we believe it is those companies that invest for the future that will succeed. Huge investment is required into sustainable energy and to reduce Europe's reliance on Russia's gas resources. Oil producers have posted large profits so far this year and those that look to use their windfalls to reduce debt and invest in methods to achieve net zero will do well. Retail is at a disadvantage as consumer preferences move away from non-food discretionary goods towards staples, as households feel the effect of inflation.

What could be the most suitable asset allocation at this time?

Equities had a challenging first half of the year and although we experienced a slight rally through the summer, we do not anticipate markets will recover losses by the end of the year. We think US equities have potential as the US economy is more self-sufficient than most European or EM countries, and there are incentives for companies to develop not only more sustainable products – for example, electric vehicles – but to source components nationally, thereby encouraging reshoring which will support economic growth. In fixed income we would favour bonds at the higher quality end of the curve which we would expect to be less impacted by market uncertainty.

What are your expectations for the energy-gas-commodities sector and the impact on companies?

Commodity prices had already started to rise prior to Russia's invasion of Ukraine. But as we head towards the winter months demand is likely to increase further, so combined with Russia's restriction of oil and natural gas supplies to Europe we would expect to see energy and gas prices push higher. Companies face similar increases in the cost of energy consumption and those that have large inventories and goods-focused production will be more at risk, whereas those that offer a service or a product where they can maintain pricing power will benefit. However, we think that given the highly volatile European gas market environment, utilities have had limited ability to hedge inventories, leaving them with limited ability to pass on lower prices to consumers should prices retreat from current levels.

In energy and metals markets, investment can take years to deliver production increases. In agriculture, weather (including climate change), labour and fertiliser shortages are an obstacle to the urgently needed ramp-up in production. The ever-growing need for countries to secure sufficient food and energy supplies will only exacerbate tight supply, especially as countries around the world struggle to contain soaring inflation. With commodity inventories so low, any external shock, impediment or constraint is likely to have an outsized impact on prices and market volatility; such circumstances do not encourage investment in production.

Companies in a position to invest in sustainable energy, and that produce goods or services to benefit a circular economy such as semiconductors or automation, will have a more optimistic outlook over the coming months.

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