

The Investment Podcast



Episode 25: The Investment Podcast: CIO perspectives on 2023 and the inflation equation conundrum

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Romil Patel: Hello and welcome to this CIO edition of *The Investment Podcast*. I'm your host, Romil Patel, and today we have a very special line-up as we look ahead to 2023. Joining us today are Fabiana Fedeli, Chief Investment Officer for equities and multi asset. Will Nicoll, CIO for private and alternative assets and Jim Leaviss, CIO for public fixed income at M&G Investments. Welcome to you all. It's a real pleasure to host today's session for our last podcast of the year.

Fabiana Fedeli: Hi Romil.

Jim Leaviss: Hi.

Romil: It's certainly a year that's not been shy of seismic events, from spiralling inflation to the rising interest rate environment. Which macro environment has had the biggest impact on your respective asset class from an investment and a business perspective?

Fabiana: Romil, clearly, it has been inflation and the reaction of central banks to it by tightening, and also the fact that central banks were left far behind, so the tightening had to be quite decisive and quite quick. Let's not forget that inflation wasn't only coming from monetary sources, but we had supply bottlenecks that had already started post the Covid surge in demand. On top of that, the tragic war in Ukraine, which obviously created bottlenecks in energy and soft commodities. All of this has really affected equity markets and overall multi-asset allocation.

Jim Leaviss: For me, it's really all about the Fed [US Federal Reserve] as well. You've seen bond markets have an extraordinary move this year. All areas of bonds have sold off so far in 2022. You have credit down 20% in some areas, government bonds down 20%, no hiding places – whether it's been emerging markets, inflation-linked bonds, or whatever. Again, this is all about the Fed hiking rates. It's a really aggressive hiking cycle that we're seeing already. I think we don't just think about it in terms of the numerical amount that the Fed's hiking, but the percentage increase that we're seeing. So, rates up from 1% to 2% is effectively a doubling of interest rates and that's going to cause a lot of pain in 2023 and beyond.

For us, it's looking at the big move in bond markets and saying: "It looks like everything's cheap now, especially if things start slowing down, especially inflation starts slowing down in 2023."

Will Nicoll: Jim, it's the same that we've got in the private markets. The only thing that we have is that everything has been delayed in various bits of the market. We have some bits that are really reacting exactly the same as public markets and some that are really only just starting to understand the likely problems coming through. I think the increase in rates is exactly the point from Jim that says a 1% to 2% is quite an exciting move but if you think about a coupon for a piece of private debt that might have been 2% or 3% and suddenly is 4% or 5%, that's an extraordinary difference of the balance sheet for that company. That's definitely going to be the theme that carries on giving, I think, for 2023 as well.

Romil: Will, I'll stay with you if I may. Heightened global uncertainty and the war in Ukraine have seen a significant disruption of markets. How important is it to prepare for and price in disruption as a leader in today's world?

Will: Talking about the private markets – property, private equity – then you are spending the whole time looking at either very high-quality buildings or high-quality companies that are going to survive in whatever environment that they're in. You're always looking at the underlying assets and the quality of them to make sure that they can withstand whatever the problems are.

I think that it's very easy to become almost paralysed by the number of different risks that could come through. I think you've got to be very careful not to do that. For example, if you think about Covid, there'd been a discussion about a Sars virus coming across for a long, long time. Now, it was a slightly different one to the one that we expected, but if one had got that right and had actually looked at the reactions in terms of lockdowns, then the responses could have been quite different from actually what would've made money. We saw the biggest consumer bailout that anyone's ever seen.

It's all very well thinking about the risks that might come. As I say, it's very important that you have good companies, good buildings, good ideas and structures that are going to be able to survive these things. You have to be very careful about catastrophising too much, and getting to the stage where you're worried the whole time that the world's going to fall in.

Romil: Jim, how do you see this?

Jim: I totally agree with Will, it does become easy in our job watching 24-hour news to always be thinking about worst-case scenarios. Look at emerging markets – if you lived in that kind of mindset, you would never buy anything. There's always something – there's always a revolution, a food crisis, a natural disaster, a war somewhere in the world. Yet when we look at valuations in emerging market bonds at the moment, some of those good-quality issuers have yields of 10%, 11%, 12%.

What's important for any investment manager is to not just think about news flow and the things that keep you up at night, but say: "Am I getting paid enough to compensate me for those risks?" We know that they're always going to be here, there's always going to be a recession in two years' time, five years' time. If that puts you off investing in corporate bonds or investing in emerging markets or right now, government bonds, you'd never buy anything. Your fundamental starting point is what is the additional yield I get for lending money to a high yield issuer or an emerging markets relative to what I could get in a bank account or in a safe government bond?

If that's more than your expected losses due to defaults because we know defaults will rise in 2023 and 2024 but if what's priced into the market is pricing in another Great Depression, then you should be buying corporate bonds or high yield going into that world rather than running away from them.

Romil: How about you Fabiana? Interestingly you remarked on the news flow in our last podcast and what an impact that has in today's fluid world.

Fabiana: I completely agree with Jim and Will. This is a market where you can still harvest alpha but you have to think differently to the traditional ways of looking at market reactions. You really have to think about fundamentals. Every time you think about inflation not rising anymore at some point, the instinct would be to go back to the meme stocks, to the extreme growth stocks that have long-term promises of earnings but probably need those earnings to be funded for a long time.

That is not the answer in this market. You've seen what has happened with crypto companies. You have heard Jim talking about higher defaults going forward, but it's also true that you can find companies where valuations are now at depressed levels and, yet, they have fundamentals that are defying the slowdown in demand. You've seen it in recent results, earnings results, where companies – just because of differences in exposure, in balance-sheet strength, and generally also in the quality of management – have had very different results. It's still a market for alpha, but it really defies those traditional ways of looking at inflationary impacts.

Romil: Jim, 2022 has seen inflation clearly move beyond transitory and it's now structural with inflation now at 41-year highs and tighter monetary policy. How do you see the inflationary path playing out in the UK, the US, and the EU and where are you seeing a consensus emerge if any, and more importantly, where do you agree or disagree with that consensus?

Jim: You're right. If you look at central bank's inflation targets at 2%, we're five times higher than that in the UK at the moment. The US is also up there as is Germany and other bits of the world. The other thing we also know is that there is an element of transitory. I know it's become a bit of a dirty word and people mock the fact that people have been talking about transitory now for a year and a half.

It is clear that base effects, i.e. where prices were a year ago will have a big impact in 2023 on what the headline rates of inflation are and people will start becoming a lot less scared of inflation when they see those headline rates come down – and perhaps quite rapidly. Towards the end of the last quarter of 2022, we perhaps saw signs that US inflation had started to roll over. We've got a European gas problem over the winter so we don't know whether the headline rate will come down as quickly there, but I think by the middle of next year, you'll be seeing significant falls of inflation.

I'm not saying central banks will then start worrying about deflation again, which has been really the story of the past 30 years. Some of the big secular trends that have kept inflation low still very much remain in place. Technological change has

driven down wages – Uberisation of the labour force, or think about the impact Amazon has on the ability of us all to find the lowest price wherever it is in the world, that's going to continue. Globalisation has been slightly under threat with some trade wars and Brexit and things like that, but on the whole, we're moving from a less global world to a more global world over the decades to come and that will drive inflation down as well. My guess is that in a year's time, we'll be nothing like as worried about inflation as we are now. Luckily, that will give central banks some room to cut interest rates down in response to what well may be a recession.

Will: Jim, the one thing that I see with the inflation bid is that we've had such an extraordinary period of negative interest rates that with everybody getting used to negative interest rates and getting used to the excess liquidity coming through from that, I don't think we're going to go back to those positions even when inflation comes down. I think that feels to me like still a bit of a risk as everybody goes back to what they think is normal, but normal really wasn't because normal was negative interest rates and normal was excess liquidity available just about everywhere.

Fabiana: I very much agree with what Will is saying. If you look specifically at equities, even if inflation comes down sometime later next year, you still have very high cost of funding. So, companies will have to deal with difficulties from a balance sheet standpoint, if the balance sheets are not strong enough. At the same time, we are going to shift the attention to how deep a recession is going to be, if indeed there is going to be a recession. In many countries, it looks like that will be the case, and, don't forget that equities do not like recessions.

Obviously, a lot of the heavy lifting in markets has been done. If you've looked at recessionary periods at the beginning of the '80s, of the '90s, of the 2000s, there had been quite a big drop in equity markets before the actual recessions, and then enter into recessions was the last shoe to drop. That means that we are closer to the light at the end of the tunnel of rate hikes and inflation rising, but we're still in darkness and that darkness will probably still create some uncertainty and volatility when it comes to equities.

Romil: Fabiana, with that reference of there being light at the end of the tunnel, what are some of the key events and pieces of economic data that you think could signal a change in market sentiment or indeed, direction in the year ahead?

Fabiana: Clearly having a confirmation that we are over peak inflation, particularly at the core end. We have seen some initial signs, literally in the last couple of CPI and PPI reads, in the United States. We're not there yet in other countries, but already seeing it in the US would be a big, if you want, help for the sentiment of the market. The other elements that we're watching is obviously geopolitical risk. Any satisfactory ending to the tragic war in Ukraine, which actually comes with an agreement and a lifting of sanctions, would of course help markets.

These are all events that are not as likely in the very close term, but just seeing some improvements there would very much help sentiment, and also of course how deep a recession will be, that will be key.

Jim: I think for me it will be around the employment market. If you think back to the global financial crisis, everyone talks about the recovery from that crisis as a jobless recovery. This is exactly the opposite. The recovery from Covid has been one where we have full employment in the UK and in the US. If you look in the UK, we have as many job vacancies as we have people out of work at the moment. I think it's the tight labour market puts central banks ill at ease. That's what they worry about. They worry that high consumer prices – thanks to the war and thanks to commodity prices – mean that labour, i.e. workers, will demand higher and higher wages. They think back to the 1970s and wage-price spirals that ended up with more and more wages, meaning more and more high prices and so forth.

I think that's less likely to happen this time in part because we don't have powerful trade unions nowadays. Capital is very much still in the driving seat there, but nevertheless, I don't think the Fed will be comfortable cutting interest rates while you have such a low unemployment rate around the world. They'll wait until they start seeing some moderation in that and in wage prices. For me, that's the thing I'm keeping an eye on.

Fabiana: That's very important because there are talks out there that at some point, the Fed will start cutting rates once it ends hiking them and that, obviously, is possibly where the biggest question mark is, and the likelihood of that happening is very limited in the near term.

Romil: Jim, forgive me if I can ask you a question here. If there were to be another black swan event and central banks had to cut rates again, do they have enough road to be able to do so?

Jim: Yes, because they've got a little machine in the corner of their office where they can press print and do whatever they want. I think I'd put that as one of my risks. I don't know the answer to this, but ever since the global financial crisis,

politicians, companies, investors like me, we rely on central banks to come riding to the rescue to sort things out by pressing print on the photocopier and doing quantitative easing (QE).

I'm not sure whether that's the right thing to do going forward. Obviously, Covid, exceptional global financial crisis, exceptional things, and I don't disagree with any of those decisions, but I wonder whether politicians now rely heavily on there never being another recession again. Is that a good thing? There is an argument that says you've got good companies and bad companies. By allowing all companies to survive at all times by providing furlough loans, cheap money, etc. the good companies will always be forced out of business by the less efficient companies and you don't get the progress and the productivity growth.

It's a really difficult argument to make if you are a central banker that you should be allowing more companies to go bust. Productivity growth in Western economies has been very poor. Perhaps one of the reasons for that is around the existence of zombie companies staying alive and not allowing newcomers to make profits. I think that we are in a slightly different world. I think that barrier to more QE is going to be a lot higher than it was historically but if a black swan that you talked about did happen again, I think that they do go into the safe and unlock the what-to-do in emergency book and do it again.

Romil: Will, my apologies for deviating, I'll come back to you. What are some of the key events and pieces of economic data that you think could signal a change in market sentiment or direction in the year ahead?

Will: I think as always, it's the things that people have got used to – the aggression in Ukraine. People have almost gotten used to the absolute idea that interest rates are going to carry on going up forever, somehow. When you look at it and any of the things changing from this year, from almost the status quo that we've managed to get ourselves into will be sufficient to make it feel significantly more cheerful about the world. It's less a question of one particular thing, it's more, I think, a question that says sentiment will shift and I think will shift quite quickly when you end up with some of these rather stale ideas.

Romil: Finally, I'd like to come to each of you for your final thoughts as we head into 2023, Will, if I may come to you first.

Will: I think 2023 is going to be very interesting firstly, because if you think about the private markets as a whole, they are reacting so differently at the moment and with vastly different time lags to the various things that we've seen over the last six, nine months. Whatever happens, there are places where there's very interesting value and there are places where there is much less value and we're waiting for the markets to react. As such, when I look at 2023, I think private markets will throw up some very, very interesting and good value ideas.

I think longer term, we are moving from a position of ultra-low rates into something that is more normalised. That means that the bits of the private markets that have grown very strongly over that period, possibly, and I say possibly because you can't be sure why they've grown – but possibly in reaction to those ultra-low rates, we may see a little bit more pressure in some of those. I still see that the general growth of the private markets continues, so it's an interesting time. This is the first credit cycle for the private markets really since they've grown so strongly since the financial crash of 2008. Therefore, there are definitely going to be places that are going to be tested in a way that they weren't expecting to be tested or hadn't been so far. Again, that will give some very interesting opportunities, I think, going through '23 and probably into '24, '25, as well.

Romil: Jim, if I may ask for your final thoughts?

Jim: We've moved from a boring bond market to a really interesting, exciting bond market with loads of things to do and lots of opportunities. You think back a couple of years during Covid, 10-year US Treasury bond yields were 0.5% and then they got up above 4% recently. You can buy investment grade, good quality US companies with corporate bond yields of 6%, emerging market bonds [of] 12%, high yield bonds [of] 10%. We've seen this complete change in the investment universe, from me thinking that nothing looked good value to me thinking that almost everything looks value, and I can almost close my eyes and just pick any of these asset classes. I think that'd be my message – we've reached valuation opportunities that for the first time in two years look brilliant. I'm buying some bonds!

Romil: Fabiana. How about you?

Fabiana: It's great to see my fixed income colleague being so bullish. For equities, it will all depend on recession. How deep will it be, where it will happen and how long it will last. For now, as we said earlier, we're closer to the light at the end of the tunnel when it comes to inflation, possibly, and also rate hikes, but we're not there yet. In this market, we have been advising our clients that this is not a market for broad-strokes investing, meaning it's not a market for big sweeping sector or country calls, but really a market to be selective, to pick up alpha when the baby gets thrown out with the bathwater.

Companies with strong fundamentals are actually sold off in a market frenzy, but actually, they have the ability to withstand the difficulties in the macro backdrop. We still think this is a market where you can harvest alpha. Going forward, depending on what we see in terms of signals from a recession viewpoint, it might be that the October lows that we have seen are the lowest point that we will deal with, but again, if a recession comes, we should probably be prepared for another leg down.

Romil: Thanks, indeed, Fabiana. Unfortunately, that's all we have time for in this special episode of *The Investment Podcast*. I hope you enjoyed hearing from the CIOs here at M&G Investments as much as I did. Thanks, indeed to our guests, Will, Fabiana, and Jim for sharing their insights.

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Fabiana: Thank you.

Jim: Thank you.

Will: Thank you.

Romil: Thank you, to you, our audience for tuning in and for your support not just today but throughout the year. We look forward to bringing you more perspectives next year, but it's goodbye for now. Have a merry festive season and a very happy new year.

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