CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

September 2022

New PM, same inflation problem

With the UK at long last announcing its new prime minister, the outlook for Ms. Truss could hardly be bleaker. Not only have fuel prices risen to such an extreme that 12 million households (42% of all households) will enter a state of fuel poverty, this has coincided with increased union action over stagnant public sector wage growth - at a time when economic activity is in decline. The task of balancing the government's books with the needs of society are difficult at the best of times, but this act is all the more delicate at present.

In anticipation of an increase in unfunded spending under a difficult economic environment, currency markets have already started to discount Sterling against other major currencies. A growing chorus of the potential for Sterling-Dollar parity and rampant inflation is understandable but perhaps still in the extreme in our view. In any event, the uncertainty we are witnessing surrounding the UK economy is likely to continue. However, with a Prime Minster finally to be held to account, at least some form of reactionary policy adjustment to dampen the impact of spiralling energy prices on consumer pockets should help. As is normal with an incoming PM, we do not expect all policy pledges adhered to. The promise of dramatic tax cuts will have to be curtailed to balance increased government spending or subsidies (particularly for those in the greatest need of this) to tide the UK population over a difficult period ahead.

The wider market fear is that all this will lead to a depreciation in UK government bond valuations, which will push up discount rates and further hinder risk asset performance for UK based investments over the coming period. Meanwhile, consumer pockets (a key driver of the economy) are increasingly being pinched by inflation and this does not bode well for spending and corporate performance. We are positioned defensively with this in mind to help dampen the blow of the negative outlook. Our hope is that policy makers will find the right balance between fiscal prudence and societal support over the coming period – no easy task.

Looking further afield, the commitment by global central bankers to bring inflation under control, despite the inherent risks to the growth outlook, shook both equity and bond markets recently. We understand their concerns but, at the same time, recognise the issues are supply-side rather than demand-side driven in nature. Hiking borrowing rates is not going to help funding for the development of further shale oil fields in the US, for example, which could go some way to helping resolve the world's dependence on Russian energy. We do wonder whether the US Federal Reserve is simply pushing the global economy towards a recession to some extent and further exacerbating current inflationary issues. However, the economic data released recently has generally been a bit better than expected, as shown by economic surprise indices, while global inflation pressures started to ease on the back of lower commodity prices. Whether this persists, however, is another matter.

All in all, the level of uncertainty about the outlook for the global economy remains elevated. This uncertainty is especially heightened in Europe. After six months of war in Ukraine there is no sign of a ceasefire, and a recession seems increasingly likely this winter as the region's energy crisis continues to intensify. We continue to hold allocations to the energy sector as a result of this and believe that the current valuations, while having recently risen, are still depressed relative to the underlying cashflow and profits being generated. Sterling looks set to continue to struggle and, therefore, global diversification remains prudent. Finally, inflation protected cashflows from infrastructure and other assets remain a key feature in our positioning to navigate the period ahead.

It will most likely prove to be a tough winter for markets, but we continue to look to shelter investor capital from current market events as best we can. This is with a view to adjusting positioning in due course, as further valuation compression occurs over the coming period and the relative attractiveness of more economically sensitive sectors catches our interest again. The timing of this will be critical to avoid further downside risk but, when inflation begins to peak and commodity prices start to fall once again, we believe conditions will begin to form again for further broad market gains in the years ahead.

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