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How to invest in a world of low growth, high inflation and high rates?

A macro environment like no other

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Image: Fiona Frick, (pictured) CEO of Unigestion

Inflation has made a marked comeback in the last few years with Russia's invasion of Ukraine earlier this year, and the worldwide easing of restrictions related to the Covid-19 pandemic in 2021.

Our proprietary Nowcasters, developed to gather timely data sets in order to build near real-time indicators, show that inflation risk is actually in the process of plateauing but at a very high level from an historical perspective.

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Inflation has not been this high for 40 years. What had started as a commodity linked-inflation has now shifted to include core inflation components. At the same time, we are contending with the strength of the US dollar as European central banks must curb currency weakness to fight imported inflation.

These inflationary forces are having knock-on effects throughout the economy, dampening growth expectations. Today's inflation increase has translated into higher input prices. These are damaging corporate profitability, forcing companies to reduce investment and capex, while higher final prices are hitting consumers even harder.

Mini Budget-induced LDI crisis was 'full scale liquidation event'

Furthermore, central banks are now adopting a decidedly hawkish tone, showing their determination to bring inflation back under control and therefore increasing the risk of the global economy heading into recession.

Finally, as the macro environment continues to deteriorate, systemic risk arises such as the alteration of liquidity in the government bond market, which is a key allocation of our institutional investors portfolio.

Market stress levels remained elevated in September. Sentiment dropped to extreme levels of pessimism, with correlation shock gathering pace and the downside velocity becoming significant.

Revisiting asset allocation

This change of economic paradigm means that revisiting asset allocation is a key priority for investors. Over the last decade investors have benefited from a bull market, almost no volatility, dispersion in returns and Beta-driven performance. We are now coming to the end of this abnormal period.

There will be no more negative interest rates and central banks injecting massive liquidity into the market (the UK has been an exception in recent weeks given tax cuts announced but now cancelled agenda). This will mean more risk, more inflation and more dispersion.

The world has quickly transitioned from a high growth, low inflation and low rates environment to one of low growth, high inflation and high rates. This means that asset allocation must also transition.

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Though most assets have seen valuations 'improve', investors must mind the valuation trap. Most assets are now discounting a slowdown, but not a proper recession yet.

All eyes on Bank of England as inflation returns to 40-year high

Furthermore, a combined correction in equity and bond markets have put institutional investors in a very difficult position. They have no place to hide with the added difficulty of realising profits to reinvest somewhere else.

Although cash is the best investment so far, it will not be able, in the long term, to protect against an inflation rate of around 8%. If some investors are considering going back to bonds, one needs to be mindful that yields need to be high enough to counteract inflation while leverage should be low enough to enable the government or the company to pay its interest.

The outlook is still rather foreboding, but having an outlook at all means that asset allocators can plan. For the next decade, performance will not be driven solely by top-down market allocation but also by bottom-up selection. There is a need for rigorous risk management and selectivity.

Invest in the real economy - but selection will be key

I would argue that even though recession risk is high, allocating assets to economic activity through equity and private equity is key.

In the context of higher inflation risk and lower growth prospects, corporate margins generally come under pressure and impact profitability, but not all sectors are equal. Investing in sectors which are more immune to GDP is of utmost importance, as is investment in companies that have pricing power to transfer inflation onto consumer prices, while controlling for leverage.

For equity investors, it is a great time for active managers to prove their skill. During periods of high inflation risk, we see strong performance from defensive sectors such as Health Care, Consumer Staples and Utilities. The outperformance of these sectors arise from their unyielding demand on consumption, inflation and growth shocks. An example may be in the provision of public services such as Health Care, or Utilities in a regulated

monopoly where growth prospects are less sensitive to GDP growth expectations. Furthermore, the increasing reliance of consumers and businesses on digital technology has led to the emergence of a new class of defensive technology stocks. Across the technology infrastructure spectrum - from telecoms through to hardware and enterprise software - the economics of these industries increasingly reflect those of traditionally defensive sectors.

Investors are also increasingly heading towards illiquid strategies and private equity, which provides an engine of growth and a tool against inflation. But here again selectivity will be crucial.

Fund managers are sacrificing long-term gains for capital survival

In the second half of 2022, the private equity market has shown signs of softening with investment activity materially lower in Q2 as opposed to a year ago. However overall levels are on par with pre-Covid (2019) investment activity. Deal volume has been particularly stable at the smaller end of the market.

Our Private Equity team continues to see a high level of compelling opportunities through our global network of over 700 investment partners. However, there is high dispersion between Private Equity styles as well as well as between sectors and size of underlying companies.

We prefer to invest at the lower end of the market while we see a reduced number of attractive targets at the larger end, especially public-to-private which tend to be a large proportion by value of larger deals.

In H1 2022, our team committed €528m to investments, including €138m invested in seven secondary transactions and €178m invested in seven direct investments and various add-ons.

We would favour investing predominantly in the small and mid-cap market and in niche sectors which have pricing power regardless of the market environment.

One US company we invested in, for example, helps clients navigate logistics with software that streamlines processes, and provides cost-saving insights. Our world is e-commerce-driven, no matter the economic backdrop, and the cost savings they offer drives demand as other costs increase in a downturn.

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I would not claim private equity will always provide protection against inflation but it is able to play to its strengths during rocky and questionable economic environments. In many ways, equities and private equity are rhyming assets and therefore must navigate similar obstacles. The best results will come to those who plan ahead, select well and heed all indicators.

Fiona Frick is CEO of Unigestion