Where next for inflation and interest rates?

2022 saw inflation and interest rates rise to levels not seen for well over a decade, but what does the new year hold for them both? Some of our equity and fixed income managers share their views and look at the opportunities for investors in 2023.

Cormac Weldon

30 December 2022

US equities: Recessions usually follow spending booms. We have not seen that excess in the US

Cormac Weldon, US equities manager

Interest rates are higher than they have been for some years, but investors can overplay concerns. Usually, recessions follow big booms in consumer and corporate spending. We have not seen that excess.

Rising interest rates have resulted in the P/E valuations of growth stocks tumbling. Mortgage costs have risen for homeowners – from c3.5% to c7% in a year and demand for new homes has fallen markedly, which has also had an impact on share prices in this sector.

Warren Buffett said it is only when the tide goes out that you see who is swimming naked. We have reached the point where the markets seem to be assuming everyone is skinny-dipping.

Dare to look closely and you can find plenty of fully-clothed businesses in the beaten-up sectors whose share prices are being unfairly marked down because of these unwarranted assumptions.

At some point inflation will be tamed, interest rates will come down, and we expect share prices in these beaten-up sectors to recover. You cannot wait until the fundamentals change to buy these things.

The time to buy is just before the tide turns.

UK equities: Strong labour markets should drive strong economic growth

Ed Legget, UK equities manager

The good news is that it looks like we are now at the point where inflation has peaked, with the first clear signs that inflation is falling in the US and Europe.

In the UK we are not quite at that stage, but as the sharp rises in energy prices in 2022 start to annualise, we expect inflation will begin to fall quickly from March.

In addition, supply chains are normalising and commodity prices are now a long way off their peaks

So, whilst inflation looks set to fall sharply around the world over the next six months, it remains far from clear that the core components of inflation -in particular labour inflation- will return rapidly to the long-term trend.

Employment data on both sides of the Atlantic remains pretty buoyant and wage inflation remains elevated. Whilst some companies we are seeing are saying that labour shortages are not quite as acute, they remain keen to retain the staff they have and many are budgeting on mid to high single digit wage inflation next year.

If labour markets remain strong, we believe we can expect economic growth to also be stronger than current forecasts. One of the consequences is that the runway for a soft economic landing in the face of tighter monetary policy is wider than generally perceived.

However, this is a long way from consensus, with the 2023 recession by far the most widely-forecast over the last fifty years.

UK small-caps: survival of the fittest will replace lost jobs and pay more taxes

William Tamworth, UK equities manager

Consumer confidence is at an all-time low. UK inflation rates are above 10% and may still go higher. We have lived through a decade of low interest rates, plentiful money supply and low business failures. The authorities have responded to any sign of weaker demand with yet more stimulus. Until now.

Small-cap debt is inconsequential in comparison to that of many companies in the hands of private equity. These privately-owned companies are often highly indebted and account for a greater share of the economy than ever before.

We have to brace ourselves for more business failures. Rising interest rates mean that many businesses that might have died much earlier but have been kept alive by cheap credit will fall by the wayside.

We should not grieve too heavily for them. Those that remain – the fittest survivors – will have the opportunity to increase their market share, replacing lost jobs and paying more taxes.

Corporate bonds: setting-up for compelling returns over the medium term

Grace Le, corporate bond manager

We believe inflation will remain elevated in the short-term and will take time to normalise to levels that we are all more accustomed to.

The target inflation rate for both the Bank of England and the Federal Reserve is 2% and it seems unlikely this level will be achieved in 2023.

What we can say with confidence is we are getting ever closer to the 'zone' for peak inflation across the UK.

So, if we take today's fixed income yields and compare them against the likely medium-term profile for inflation UK (as currently priced by the market), we believe bonds are setting up for compelling returns over the medium term and returns that will outstrip inflation over the years to come.

Cormac Weldon

Manages:
US equity strategy

Cormac has managed Artemis' US equity strategies since launch.

Ed Legget

Manages:
'UK select' strategy, 'high income' strategy

Ed manages Artemis' 'UK select' strategy and also co-manages Artemis' 'high income' strategy.

Grace Le

Manages:
Bond strategy

Grace is a fund manager in the Artemis fixed income team.

William Tamworth

Manages:
'UK smaller companies' strategy

William works with Mark Niznik managing Artemis' 'UK smaller companies' strategy.