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January 2023 Quarterly Market Update: Rising inflation and challenges for ESG

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To this list of suspects, Andrew Garrett, Investment Director at Perpetual Private, adds a long period of loose economic policy – specifically Quantitative Easing (QE) (policies designed to make money ‘cheaper’ to stimulate demand in the economy and encourage investor confidence).

"By 2022 investment markets had become foolhardy,“ he says. “With policy makers deploying QE even in ‘normal’ economic times, our addiction to low rates had pushed too many investors up the risk curve. Investors had begun to believe that markets could defy gravity. But they never do.”

And now what?

In his December Monetary Policy Statement[2], RBA Governor Philip Lowe predicted Australian inflation would peak at around 8% but decline in 2023 due to “the ongoing resolution of global supply-side problems, recent declines in some commodity prices and slower growth in demand.”

But will moderating inflation shift the investment environment back to pre-COVID harmony? Perpetual Private thinks this is unlikely.

- Volatility will persist as markets continue to adjust to a higher inflation, higher rate environment.
- The overwhelming force of 2022's rate rises mean growth will be lower. In the Statement quoted above, the RBA predicted Australian economic growth of just 1.5% in 2023 and 2024.
- Inflation will moderate and the pace of interest rate rises likely slow. But rates are still likely to settle at higher levels.

Implications for investors

However, Andrew Garrett says a tough macro environment doesn't mean investors can't make money.

If they act both carefully and decisively, smart investors can use volatility to sell into peaks and buy in troughs. Value shares should continue to outperform as investors prefer companies with what Andrew calls "clear and present cashflows" to those with attractive but uncertain growth prospects.

"In this new and still evolving investment environment, many investors will be caught over-reacting to the latest information drop," says Andrew. "What's needed are cool-headed decisions, the ability to look through the noise, avoid over and under confidence and focus on long-term goals."

New trends in ESG

Many NFPs are interested in ESG investing (investing that takes into account Environmental, Social and Governance issues). Over the past few years, fund flows into ESG products have been spectacular. But 2022 saw two trends that might affect future growth.

One is rigour around what actually qualifies as ESG investing. What are the standards? How is it measured and reported? Are those numbers verifiable and comparable? This lack of clarity feeds into growing cynicism about corporate greenwashing – defined by ASIC as "misrepresenting the extent to which a financial product or investment strategy is environmentally friendly, sustainable or ethical.[3]

Moves by organisations such as the International Sustainability Standards Board to create 'high quality, transparent, reliable and comparable reporting on ESG matters' are an important step to make sure ESG investing delivers on its promise and that investors are fully informed.

Whilst the debate about ESG authenticity raged in 2022, a more direct threat emerged. According to Reuters[4], one U.S. fund manager lost mandates worth USD 4 billion in Republican-led states who cited concerns over ESG impacts on member returns – and about the funds' hostility to resource industries in those states.

Perpetual Private's Andrew Garrett says these are two trends the ESG community needs to manage. "After such strong growth, it's time for a bit of reflection. If proponents of ESG can understand and respond to these trends, they'll be able to drive future growth."

Perpetual Private's Quarterly Investment Update for January 2023 covers the Great Inflation debate in detail and looks at the outlook for equities, fixed income, real estate, currency and alternatives.

Download the report

[1] Broadly speaking, countries have different cost advantages in producing different goods (e.g., Australia is an efficient producer of wheat and many resources). So it makes sense for countries to trade with each other to capture those efficiencies.
[2] See https://www.rba.gov.au/media-releases/2022/mr-22-41.html
[3] https://asic.gov.au/regulatory-resources/financial-services/how-to-avoid-greenwashing-when-offering-or-promoting-sustainability-related-products/
[4] https://www.reuters.com/business/finance/davos-2023-blackrock-us-inflows-dwarf-4-bln-lost-esg-backlash-ceo-2023-01-17/
Sources: https://www.bloomberg.com/news/articles/2022-12-13/esg-market-in-us-significantly-smaller-than-previously-reported

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