COLUMBIA THREADNEEDLE INVESTMENTS

COLUMBIA INTEGRATED US DIVIDEND INCOME STRATEGY

As we begin 2023, we are maintaining a valuation discipline and focus on quality in our portfolios.

Market overview

Persistent volatility and fears of a global slowdown marked the fourth-quarter. October and November brought positive market returns as inflation finally started to cool slightly and many investors looked to a potential end of the U.S. Federal Reserve's current tightening cycle. While the Fed reduced the pace of tightening from 75 basis points earlier in the year to 50 basis points in December, Fed Chair Powell maintained a hawkish stance, continuing to stress the Fed's mandate to rein in inflation over maintaining full employment. While Fed moves operate with a lag, outside of some relief in the rate of year-over-year inflation metrics through November, there remains upward pressure on wage growth and the employment picture looks solid despite some high-profile layoffs in the information technology and financial services sectors. Consumer spending remains good enough, especially around services, to keep the economy growing despite the rapid pace of Fed interest rate moves this year.

Typically, tighter monetary policy would tend to slow global growth, but signs of any deterioration remain nascent outside of the sharp slowing in the housing market. U.S. third-quarter gross domestic product (GDP) was up 3.2% year-over-year, and the Atlanta Fed's GDPNow forecast for fourth-quarter GDP growth currently sits at 3.66% despite the rapid Fed tightening that produced negative returns for both stocks and bonds for only the third time since 1931 (1931 and 1969 were the other two years when this occurred).

How far will the Fed go in the current tightening cycle? It is hard to tell but fed funds futures currently discount another 50 bps of tightening by the March 2023 meeting, bringing the terminal rate in sight of 5%. The median Fed dot plots from December suggest a 5.25% terminal rate. There are differing opinions regarding when or how much the Fed will decide to cut rates. Right now, it appears that the Fed will need more evidence of slowing inflation before it decides to hit the pause button. A lot will depend on the jobs outlook. Current data suggests that futures traders may be too optimistic in calling for an end to the tightening cycle next spring because wage growth remains elevated. Per Bloomberg, earnings historically decline approximately 16% during recessionary periods. Right now, the S&P 500 Index consensus estimates are calling for 2.3% year-over-year growth for 2023, down from a 6.5% estimate at the beginning of September.

Company fundamentals and cash flows aren't the only things driving the markets. Geopolitical situations such as Russia's war on Ukraine, China's abandonment of its zero-Covid policy and elevated U.S./China tensions remain overhangs. These geopolitical situations bode well for continued strength in energy prices but not much else as we closed out the year.

Performance and positioning

Nine of the eleven global industry classification standard sectors of the S&P 500 Index posted positive returns for the quarter, with only the communication services and consumer discretionary sectors finishing in negative territory. Across the broad large-cap universe, our process was negative with the fundamentals theme was the primary detractor.

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Sector allocation and security selection both made positive contributions to relative performance for the quarter in comparison to the S&P 500 Index. The strategy's underweight position in consumer discretionary and overweight position in energy added to relative performance, while an overweight in real estate and underweight position in the consumer staples sector detracted the most from relative performance. Stock selection was strongest in consumer discretionary and information technology, while stock selection detracted most within materials and financials. Top relative individual contributors for the quarter included Merck and Broadcom, while top detractors included CF Industries and Fidelity National Information Systems.

Outlook

Fears of both an earnings recession and potential economic recession have us cognizant of further downward pressure on earnings multiples, especially within the growth-heavy information technology sector. Therefore, as we begin 2023, we are maintaining a valuation discipline and focusing on quality in our portfolios. Market sentiment remains at multi-year lows but we continue to look for an inflection point or sentiment shift that could cause a sustainable rally in the battered growth-stock universe. With interest rates firmly positive, fundamentals such as earnings and cash flow (rather than liquidity provided by cheap money) will likely be the drivers of returns in the new year so our process should be favorable.

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