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COLUMBIA THREADNEEDLE INVESTMENTS

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Cover story:

Finding good news in a changing macro environment

Also in this issue:

What to expect in 2023

What we don't know about inflation

FEATURED STORIES

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ALSO INSIDE

Winter 2023
Volume 13 Issue 1

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Columbia Threadneedle Investor Newsletter is published quarterly online and features timely articles covering economic trends, investment strategies and solutions, and service changes.

FINDING GOOD NEWS IN A CHANGING MACRO ENVIRONMENT

Given the risk of a recession, focusing on quality will be essential for success — across asset classes and regions.

After a difficult 2022, cautious optimism may be in order. Here are our thoughts on market risks and opportunities heading into 2023.

WILLIAM DAVIES
Global Chief Investment Officer

After a dismal year for the markets, we asked Global Chief Investment Officer William Davies to share his thoughts on risks and opportunities in the market as we head into 2023. While there is plenty to be cautious about, a repeat of 2022 seems unlikely.

No more bad news should be good news

Through 2022, the market repriced for bad news — the Russian invasion of Ukraine, supply chain woes, stickier headline inflation and rising rates, expectations for a recession. For 2023, we may see these macro conditions continue. But as long as they don't get significantly worse, investors may begin to feel more optimistic and we might begin to see better market performance. While there's always risk, no more bad news could end up being good news for investors.

Expect the inflation and rates story to be different

Headline inflation should come down in the U.S. unless energy prices take off. Core inflation is likely to be stickier, but stable/lower readings mean that rate hikes could stop in 2023. The European Central Bank (ECB) probably has more work to do than the Fed at this point. However, the ECB won't need to raise rates as high as the Fed has. We have a little less clarity on inflation in Europe given the war. I don't expect rates to come down in 2023, but an end to the guessing game about "how high" may be a positive catalyst.

A recession playbook with a twist

It seems inevitable that Europe will see a recession in 2023. In the U.S., we'll have to watch the Fed and how much economic pain it deems necessary to beat inflation. I don't think that we'll see a recession along the lines of what we saw in 2020 or 2008, but given the risk, focusing on quality will be essential for success — across asset classes and regions. Credit quality is likely to be a much greater determinant of success than duration in fixed income in 2023 (relative to 2022 when duration was the key driver). Also, the quality of earnings and balance sheets is a likely requisite for success in equities.

The same focus on quality applies to relative opportunity across regions. The indiscriminate fall in valuation has created some opportunity in markets, but without thorough analysis, you're unlikely to find the winners with strong balance sheets that can survive a mild recession. This goes for regions, too. Usually in a recession you'd avoid economically sensitive sectors, and I do think investors will need to be cautious here. At the same time, some services are getting a lift from a post-COVID "return-to-normal," which creates opportunity even with the prospect of recession.

A slightly less strong U.S. dollar

The strength of the U.S. dollar in 2022 has been driven by the speed and extent of increases in the federal funds rate, the global uncertainty and to an extent by the continued strength in the U.S. labor market. The dollar's strength has contributed to unease in emerging markets and higher inflation generally outside the U.S. — especially given that many goods, commodities in particular, are priced in U.S. dollars.

As we anticipate a levelling off in the federal funds rate in 2023, this dollar strength should abate. Or, at the very least, we should see less upward pressure in 2023, which is another potential positive for capital markets.

Geopolitical risk remains on the table

It's very difficult to calibrate the risk of escalation in the ongoing war in Ukraine — or regime change in Russia for that matter. In Asia, rising tensions between China and the U.S. have introduced heightened risk for emerging markets and made us cautious, even while valuations there are attractive. (It would be in both countries' interest to get along; maybe recession would encourage them to collaborate more.) The markets did not anticipate the Russian invasion as we entered 2022, and it's possible that a similar blind spot occurs heading in to 2023.

WHAT TO EXPECT IN 2023

EQUITIES: FOCUS ON QUALITY FOR SUCCESS

To succeed in 2023, you'll really need to distinguish between companies that are more resilient and those that aren't.

MELDA MERGEN, CFA, CAIA

Global Head of Equities

2022 was a bruising year for equity markets, and I don't think investors should expect everything to go "back to normal." Higher inflation and a weaker economic environment will mean that not all companies will thrive. Here's how I'm thinking about opportunity as we head into 2023.

Inflation will begin to settle down, but it will settle at a higher number than we had pre-pandemic

As the economy reopened after the pandemic, we saw many one-off drivers of inflation. At the same time, longer lasting drivers have also been unleashed. We're seeing changes in supply chains (reshoring and building out new networks) and geopolitics, and these don't resolve quickly. I expect inflation to fall, but not back to pre-pandemic levels. When a dislocation like this happens, you never go back to where you started — and where we end up is one of the key questions for 2023.

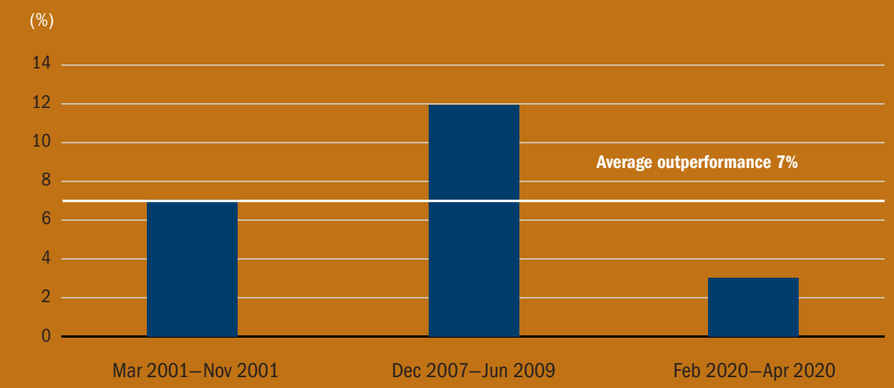
At the lower end of the growth spectrum, we'll see a re-rating in valuation

Inflation generally means equity valuations come down, and we saw that through 2022, but on a broad market basis. I think that we'll see greater dispersion in terms of valuation in 2023, with longer duration equity — companies with growth expectations farther out in the future — suffering more. Investors will have to be more careful about what they're willing to pay for future earnings, and demands for profitability will come sooner. All of this means that companies that can't deliver earnings are more likely to see the market take down their valuation.

[1] FTSE Russell as of March 31, 2022. 39.2% of Russell 1000 company revenue comes from non-U.S. sources, compared with just 17.9% of Russell 2000 company revenue.

The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. The S&P 500 Quality Index is designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio. The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 Index tracks the performance of 1000 of the largest U.S. companies, based on market capitalization. It is not possible to invest directly in an index.

DURING RECESSIONS, QUALITY STOCKS OUTPERFORM THE S&P 500 BY AN AVERAGE OF 7%



Source: Bloomberg as of 10/31/22. S&P 500 Quality Index vs. the S&P 500 Index. The S&P 500 quality score is calculated based on return on equity, accruals ratio and financial leverage ratio. Periods of recession determined by The National Bureau of Economic Research (NBER) Business Cycle Dating Committee.
Past performance does not guarantee future results. It is not possible to invest directly in an index.

How much cash a company has on hand is going to matter more

Many investors think of valuation in terms of P/E multiples. That metric is useful, but it's not the only measure of a company's value. I think that free cash flow will be a more important metric because it will provide a good indication of how resilient a company may be in a high-inflation, weaker economic environment. Cash on hand can also help deliver stock buybacks, which can support a company's stock price. It will be a lot more expensive to fund buybacks through debt. Because of this, free cash flow and dividend growth (rather than the absolute level of yield) are both metrics that may indicate a higher quality company.

When thinking about global opportunities at a high level, the U.S. is more attractive than other regions.

There are some relative opportunities to consider, but the primary focus should be on finding resilient companies

While economic growth is slowing, at this point it doesn't look like a recession in the U.S. will be very deep. In contrast, economies in Europe are under significant stress, and a deeper recession there seems likely. In emerging markets, we've seen economies under stress from China's zero-COVID policies, the strong U.S. dollar and geopolitics. When thinking about global opportunities at a high level, the U.S. is more attractive than other regions. I also think that small caps may offer greater opportunity than large caps — especially since larger companies tend to have greater non-U.S. revenue exposure (~35% of revenue is outside the U.S.)[1] — and that a tilt toward value over growth still makes sense.

You'll need to go deeper than big-picture observations to succeed in 2023 though — meaning an active, company-by-company approach. Passive indices (especially in international) can have embedded concentrations that can hurt portfolio performance. The key will be to distinguish between companies that are more resilient and those that aren't.

FIXED INCOME: BULLISH ON BONDS

GENE TANNUZZO, CFA
Global Head of Fixed Income

I don't think that we'll see a repeat of 2008 or 2020, when the slowdown was extraordinarily deep in specific areas of the economy.

The driver of fixed income will shift from rate hikes to the economy (and probably recession)

Rate hikes and tighter financial conditions drove fixed-income returns lower in 2022. Heading into 2023, we should see the economy slow pretty dramatically. I don't think that we'll see a repeat of 2008 or 2020, when the slowdown was extraordinarily deep in specific areas of the economy. Instead, because financial conditions have tightened so much, I think economic pain will hit the tail of every industry. That means that companies and consumers with too much leverage, and sovereigns that are not well-positioned to deal with elevated levels of currency volatility, will come under increased pressure.

Quality and credit selection will be important shock absorbers for investors

Investors no longer have the benefit of policy-based shock absorbers like quantitative easing or artificially low rates to protect their portfolios. In the absence of monetary and fiscal stimulus, they'll need to find new buffers to cushion the impact of market and economic volatility. From an implementation perspective, this means a higher credit quality portfolio and companies with strong fundamentals, a healthy cash flow and lower leverage. It can also involve pivoting away from certain risks — including securities that are overexposed to the low end of consumer credit — and owning asset classes like municipal bonds and agency mortgage-backed securities.

Higher yields can mean portfolio protection

The broad repricing of bonds and the higher starting yields we have now can help insulate investors from further losses. The yield curve is very flat and very high, which means even if investors are not comfortable with longer duration bonds, there are attractive opportunities in short-term corporate bonds, which are yielding 5.5% or 6%.

Don't try to time the Fed's pivot from rate hikes

For those who are comfortable with longer duration bonds, pay attention to the duration narrative. I think it will shift from focusing on the aggressive Fed hiking cycle to focusing on the impact of the Fed pausing (if not cutting) rate increases. We've seen negative returns in the bond market followed by high, if not double-digit returns. However, a market response to the end of the hiking cycle generally happens very quickly and trying to time the bottom can mean an investor misses out.

Fixed-income valuations are very attractive, but pay attention to risk

With government guaranteed mortgage-backed securities priced in the mid-$80s and long-maturity investment-grade bonds in the $70s, the combination of income and price appreciation can generate meaningful total returns once sentiment turns. Similarly, investment-grade bonds, which were down 20% this year, could provide better outcomes because they represent companies that don't necessarily need to refinance in a less conducive environment. If we look at international bonds, this is probably the first time in many years that opportunities in Europe appear more attractive relative to the U.S. — particularly in investment-grade bonds, which have already priced in geopolitical risk. High yield appears fully valued to us but could stand to benefit if the economy can avoid a recession in the year ahead.

Optimism for 2023

I don't think 2023 will be a repeat of 2022. There are very compelling total return opportunities in high-quality assets. Investors are being compensated in terms of yield but there are risks; a focus on quality and credit selection will be critical to setting the stage for successful fixed-income outcomes. There are risks associated with fixed-income investments, including credit risk, interest-rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

For more information on our 2023 outlook for fixed income, watch our Insights blog video.

Today's students — tomorrow's leaders

When you have big plans for your future, it helps to have your friends there to support you. For a select group of talented students, the Posse Foundation makes that a reality. As part of our ongoing diversity, equity and inclusion initiatives, Columbia Threadneedle Investments is a proud sponsor of the Posse Foundation, a nonprofit organization dedicated to identifying high school students with exceptional academic and leadership potential and awarding them scholarships to attend select colleges and universities with a small, diverse group of other talented students — their "posse." We have been fortunate to work with several interns from the Posse Foundation.

Learn more about The Posse Foundation and its mission to create a new network of leaders that truly reflect the rich diversity of our country. Hear from Ted Truscott and the Posse members as they embark on their internship at our firm.

Watch: **Our Partnership with The Posse Foundation**

THE POSSE FOUNDATION, INC.

WHAT WE DON'T KNOW ABOUT INFLATION

EDWARD AL-HUSSAINY

Senior Interest Rates Strategist

We don't know very much about high inflation. Looking at the past hundred years of data, we're able to explain exceptionally little in terms of how it evolves. One reason is that despite a couple of relatively isolated periods — from the late 1960s through the early '80s — we haven't had a lot of experience with high inflation.

From the end of this period is where most of our current thinking about inflation begins: when the Fed first intervened to tame inflation in the early 1980s by aggressively raising interest rates. It took a while. From 1980 through the mid-1990s Fed Chair Volcker, and then Greenspan, brought inflation from double digits down to 2%.

The extraordinary thing is not that inflation came down, but the fact that once it was down, it essentially never went back up — until the middle of 2021, that is. It's this period that we find more interesting and more relevant to our current situation and thinking.

By examining the Fed's behavior since the mid-1990s, we can surmise that during this period the central bank came to two important conclusions:

- The Fed didn't have a framework for inflation that could inform monetary policy in real time. There were too many factors and not enough meaningful information.
- In the absence of such a framework, the Fed could rely instead on managing inflation expectations.

The strategy then became to do whatever it took to keep long-term inflation expectations low and stable, so as not to allow the idea of higher and more persistent inflation to get entrenched in the economy. In fact, stabilizing long-run inflation expectations, even as short-run inflation expectations rose and fell dramatically, became the Fed's inflation-busting superpower.

The great correlation flip

Another fundamental shift took place at the end of the 1990s. As the Fed stabilized inflation near 2% and inflation expectations became anchored, the relationship between risk assets and rates flipped; bond and equity performance became negatively correlated after essentially moving together for the previous 30 years. This shift can be seen as a byproduct of the low and stable inflation environment the Fed manufactured and maintained — perhaps the ultimate proof point to its success.

This new risk/rates relationship became so durable that it became a core tenet of portfolio construction. In times of recession, investors can use duration to buffer losses in risk assets — the proverbial 60/40 portfolio. That idea is embedded in almost every multi-asset strategy because it has worked exceptionally well. That relationship also affected the term premium (the return you get for taking on duration risk).

> In the absence of a framework for inflation that could inform monetary policy in real time, the Fed relied on managing inflation expectations.

The term premium declined more or less in a linear fashion over the same period, and for much of that time it's been negative. This shows once again the long-term attractiveness of longer duration bonds as a downside buffer. Investors have been willing to lose on the term premium in exchange for the reliable and effective mitigation of losses when the markets move down.

Positioning portfolios: Betting on the Fed

In the meantime, persistent inflation has also upset the risk/rates correlation truism that has dominated portfolio construction for the past 30 years. Stocks and bonds have been moving together and have been equally battered. So, the questions many investors are asking are, "Will this new relationship persist? And if so, will I have to change my approach to asset allocation?"

Based on the trends we're seeing now in the economy and markets, and what the Fed is signaling, we think the most likely scenario is that high inflation (more than 5% year-over-year) will persist through at least 2022. And this will require the Fed to continue its aggressive monetary hikes, bringing

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A different kind of inflation shock, and a credibility crisis

During this almost 30-year period of low sustained inflation, inflation shocks were predominantly to the downside. Rising inflation was the least of the Fed's concerns and it struggled to keep inflation up near the 2% target it had finally officially codified in 2012.

In an effort to manage this under-target inertia and stimulate growth, the Fed adopted the flexible average inflation target (FAIT) in 2020. The idea was to allow short-term inflation to overshoot the Fed's target to ensure that longer term inflation expectations would average nearer to 2%. This was a significant shift in policy with a laudable goal. But in retrospect, the timing could not have been worse.

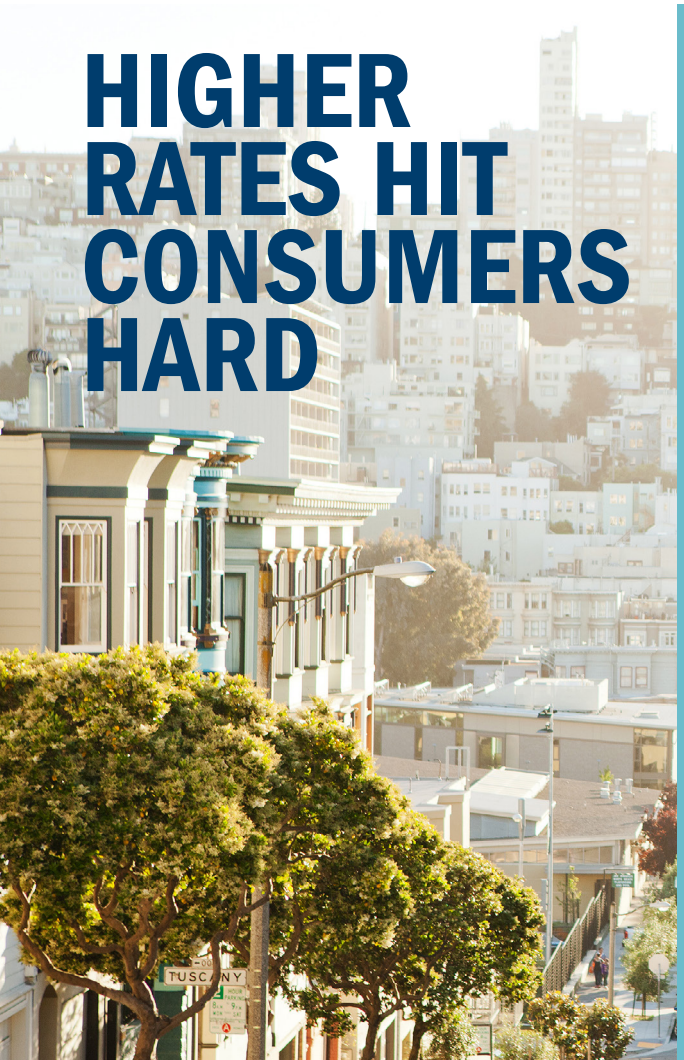
When the Fed introduced FAIT, the world was in the relatively early stages of the pandemic shutdown, with the consensus prediction that COVID-19 would wane with the introduction of new vaccines. This was not the only predication that would prove to be significantly wrong. Fiscal and monetary moves to combat the COVID-19 slowdown, combined with the ripple effects of the shutdown and changing consumer behavior, came to a head in 2021. This is when inflation began its rise to 40-year highs. The errors in forecasts for inflation expectations were massive — not just for the Fed, but for almost every private-sector forecaster as well. The upshot was a crisis in confidence in the Fed and a hit to the powerful credibility it had carefully built by managing inflation expectations and engineering a generally predictable investment environment through economic cycles.

Though it arguably took too long to get started, the Fed is now aggressively working to restore this credibility and its success in setting inflation expectations. At the end of August in Jackson Hole, Fed Chair Jerome Powell was unambiguous in his comments, signaling that the Fed will continue to tighten monetary policy to break inflation, even at the risk of sacrificing employment. It's a sign of the Fed's newfound resolve and confidence that Powell devoted almost no language to the wins in the inflation fight that the Fed has already achieved:

- Slower growth
- Tighter financial conditions relative to the start of the year
- Stable long-run inflation expectations in survey and market data
- An inverted yield curve signaling that tightening monetary policy is doing exactly what the Fed is intending

the fed funds terminal rate to a range above 4% and making the possibility of a soft landing highly unlikely. Because the risk of declaring victory prematurely is so substantial, from a credibility perspective the threshold for the Fed ending the hiking cycle must be significantly higher. Specifically, the data will need to show the labor market weakening — whether it's through a decline in the pace of employment growth or a deceleration in the pace of wage growth — which will make it harder to avoid a recession.

This scenario is consistent with the view that the Fed will be able to reestablish its "inflation fighting" credibility. We believe restoring stable inflation expectations will increase the likelihood that that correlation between risk and rates returns back to negative, making long-end duration quite attractive in the near term. For this reason, we think the death knell for the 60/40 portfolio is premature. Over the longer term, income, recession protection and diversification have been the right reasons to own duration. While we remain in uncertain territory, we don't think the current situation is going to fundamentally change that value.



HIGHER RATES HIT CONSUMERS HARD

Rising interest rates are driving homeowner mortgage payments to record highs — just one of several ways rates affect consumers.

MORTGAGE PAYMENTS HAVE INCREASED BY MORE THAN 80% SINCE THE BEGINNING OF 2021

New homes' monthly mortgage payments ($)

Source: Bloomberg, U.S. Census Bureau, National Association of Realtors, Bankrate.com and Columbia Threadneedle Investments; data as of 10/31/22. Assumes current mortgage rate, a 20% down payment and a median home price of $414,900.

Against this backdrop, fixed-income investors face increased credit risk. Deep research will be needed to uncover high-quality borrowers. For mortgage-backed investments in particular, finding bonds (and borrowers) that can weather economic uncertainty will be essential for investing success.

Investing smarter for the world you want

At Columbia Threadneedle Investments, we invest to make a difference in your world, and the wider world. Millions of people rely on us to manage their money and invest for their future; together they entrust us with $546/€558/£490 billion. We are globally connected with a team of over 650 investment professionals providing diverse expertise, spanning almost every asset class and market. We are intense about research as we believe that original independent research makes investment decisions smarter. We have a responsible ethos as investment decisions today help define the future we all seek. Every day, we're looking for opportunities to improve how we invest and what our clients experience; our focus on continuous improvement means that we never stand still. Whatever world you want, our purpose is to help you achieve it.

Source: Columbia Threadneedle Investments as of September 30, 2022.

To find out more, call 800.426.3750
or visit columbiathreadneedle.com

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