A New Era of Investing Dawns

As we settle into the first quarter of 2023, it's worth discussing the current cycle and the implications for markets in 2023—but the bigger issue is the developing likelihood we have begun to shift into a different economic and market environment, marking a different era than we have seen in the decade-plus since the Global Financial Crisis (GFC).

We likely experienced peak rates of inflation during the fourth quarter of 2022, and as price increases abate, the coming months may bring the end of the central-bank tightening. However, we believe inflation is likely to remain above the historically low levels experienced during the last decade. Tight labor markets and slowing rate of globalization are likely the key culprits.

Global central banks have been vigilant in managing these inflationary forces, and even if we are at the tipping point of the current tightening cycle, it is quite possible that interest rates remain at levels above what we have become accustomed to during the post-GFC era.

Regarding economic growth, there is great debate about whether a recession in developed markets can be avoided, but the precision is not relevant. It's clear to us that we are and will be in a slowdown during the first part of the year.

Corporate earnings growth is projected to be slower in 2023 than it was in 2022, and consensus estimates still appear too high, in our estimation. The market started to acknowledge this in the fourth quarter of last year, and we expect that will pick up in the first months of this year.

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China is a different story, as growth should accelerate as the country emerges from extended COVID-related lockdowns. However, we expect growth to be uneven and the rebound to be weaker than we have seen elsewhere given that there hasn't been as much fiscal support to boost consumption.
Interestingly, pent-up travel demand from China is likely to contribute more to persistent inflation than is generally understood. We believe that close to 300 million of China's population could be traveling abroad in the next several quarters, buoying demand for goods and services outside China and increasing inflation volatility—one of the reasons we believe inflation may prove to be stickier this year.

Against that backdrop—lower but elevated rates of inflation; interest rates remaining higher than they have been in the last decade; and sluggish economic and corporate profit growth—it will remain a difficult equity market to navigate. While the big move in valuation occurred in early 2022, we believe valuation will remain a powerful factor—in other words, market returns will likely be a function of earnings growth rather than valuation.

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But what is the nature of this environment, and where are the potential for shifts that may lead to future earnings growth, in 2023 and beyond?

We postulate that the post-GFC period has been anomalous, and going forward we can expect marginal shifts to the investing environment reminiscent of an era dating back to prior decades rather than the 2010s.

It's been well documented, but worth noting, that the unusual shock to the global economy and markets resulting from the GFC led to a decade of extremely accommodative monetary policy that lowered interest rates to historic levels.

The period was also unusual in that the expansion was quite protracted, intermittently lasting for most of the decade. We witnessed the continuation of globalization and China's ascension into the world's second-biggest economy, with still high (greater than 6%) rates of growth as key drivers—not to mention the continuation of innovation and productivity enabled by the digitalization of many areas of the industrial and consumer economy.

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Thus, we experienced long (albeit low) growth, and expansion was accompanied by modest inflation. This ultimately led to a period of strong returns for equities and risk assets, as the notion of TINA—"there is no alternative"—took hold in a low- or zero-interest-rate environment.

This situation ballooned during the pandemic, once it was clear to the markets that global central banks would do whatever was necessary to keep economic demand from plummeting. But the bubble was pricked in 2022 as inflation and rates accelerated at a historic rate.

Beyond this year, there is no reason to believe that underlying real structural growth will be materially different than what we have seen in the prior decade. If anything, there may be slight risks to the downside.

As mentioned earlier, inflation and interest rates have shifted upward, and we believe the forces that caused this may extend beyond just the current pandemic-influenced economic cycle. We are loathe to bet that inflation and interest rates will revert to recent lows in the near future, as the move from quantitative easing to quantitative tightening is just underway.

Why is this macro view important? Because it sets the stage for corporate performance, but also—and perhaps more importantly—market leadership. We believe the environment has changed enough that market leadership will be broader in the coming years than in the pre-pandemic era.

We look to previous central-bank tightening cycles for some perspective. Our analysis shows that after the peak of prior tightening cycles, inflation remained sticky, persisting for up to two years; corporate earnings growth receded; and valuation remained a dominant factor. We believe this is likely to be the case for the intermediate-term investing period.

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Despite this backdrop, we still believe companies that persistently out-earn their cost of capital, grow their asset bases with high returns on invested capital, and innovate to solve customer needs will be attractive investments. But as we experienced after the dot-com bubble, the market needs to recalibrate expectations. We experienced the first phase of this in 2022 but expect that it could take the next few years for this to fully materialize.

We believe that diversity of growth, industries, and business models at appropriate levels of valuation will make for optimal portfolio construction and investment returns. This is different from most of the 2010s, when concentrated investment strategies optimized for maximization of expected growth—in a small number of industries, and in many cases with similar business models—outperformed massively. We have seen these before: the Nifty Fifty of the 1970s and the tech bubble of the 1990s.

Each of these periods was symbolized by the concentration of market leadership and narrowness of what was favored—at the extreme expense of almost everything else. This really isn't reflective of longer-term market environments characterized by much more breadth and diversity in both the real economy and the markets.

Looking forward, we believe there should be opportunities for growth equities from numerous sources. Marginal changes to growth rates, in both directions, will likely drive investment performance. Companies with superior capital allocation strategies should prove to be attractive. We believe the delivery of cash flows will be favored over the promise of growth—in other words, lower versus longer duration. Quality, cash flows, and predictability will likely be favored. "Old economy cyclicals" that were left for dead (such as commodities and financials) may continue their resurrection.

As growth equity investors for now close to three decades, we welcome this shift back to "normal" as breadth and diversity of investment ideas have been a hallmark of our success.

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