ARS INVESTMENT PARTNERS

THE OUTLOOK

April 5, 2022

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We are heartbroken to see what the people of Ukraine are experiencing. The extraordinary leadership of President Zelensky and the bravery of the Ukrainian people in defending their homeland and families is inspiring people around the world. The defense of Ukraine is a vivid reminder of the high cost of freedom that many people enjoy but often take for granted.

Everything's Changed

"The war in Ukraine could not have come at a worse time for the global economy—when the recovery from the pandemic-induced contraction had begun to falter, inflation was surging, central banks in the world's largest economies were gearing up to hike interest rates, and financial markets were gyrating over a formidable constellation of uncertainties. The war has aggravated those uncertainties in ways that will reverberate across the world, harming the most vulnerable people in the most fragile places. It's too soon to tell the degree to which the conflict will alter the global economic outlook... Much will depend on what happens next."

– Indermit Gill, Non-resident Senior Fellow at the World Bank excerpt from Brookings Institute, March 8, 2022

Everything changed on February 24th as war is being waged on European soil for the first time in decades. There will be no winners from this war as the damage already done has been far too great in terms of loss of life and destruction of a nation. Unfortunately, the steepest economic price will be paid by the people of Ukraine and Russia followed by the world's poorest nations and households that spend the highest share of their incomes on food and energy. Besides higher prices, the fallout is likely to arrive through several other vectors: trade shocks, financial turbulence, flows of capital, and the flight of refugees. The global economy will experience higher levels of inflation leading to slower global growth.

After being supported by historically low interest rates and highly accommodative policies, market participants who have grown accustomed to strong returns across asset classes must now recognize we have entered a new economic period where different investment opportunities are presented and invest accordingly. With additional supply chain disruptions to food and energy being layered on top of the pandemic-related issues, the global economy is experiencing reduced monetary and fiscal policy support, higher levels of inflation and lower global growth.

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Source: InflationData.com

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China and Russia have been seeking a rebalancing of the global order with the desire to reduce the military and economic influence of the United States and its allies.

The world is entering a period of massive geopolitical, economic, and societal shifts. Russia's attack on Ukraine will remake the world, but it is unclear at the present time just how much things will change as we do not know when or how the war will end. What is clear, however, is that the global economy is facing another significant economic shock; the Ukrainian and Russian economies will likely be severely damaged for an extended period; Europeans will be facing significantly higher energy prices and greater prospects for a recession; the world food supply will be disrupted; global trade will undergo a significant makeover; national security has become a much bigger priority; and international alliances will be reconfigured. Countries closest to the conflict—by virtue of their strong trade, financial, and migration links to Russia and Ukraine—are likely to suffer the greatest immediate harm. But the effects will be felt worldwide.

It is worth noting that since ARS Investment Partners was established in 1971, we have successfully navigated previous inflationary periods for our clients as well as several geopolitical conflicts during that time. Our investment process, which combines both proprietary macro-economic analysis (top-down) and fundamental company research (bottom up), gives us an advantage in being able to invest in the secular themes to position ahead of shifts in capital flows as we have in recent years. We began overweighting semiconductor and capital equipment companies, defense companies, electric vehicle manufacturers, and commodity producers essential for the clean-energy transition often well in advance of major market shifts. We have employed the same investment philosophy and approach since our inception, and that approach has allowed us to successfully build and protect capital in challenging environments. The most important consequence of the war in Ukraine is the lives lost and the humanitarian crisis associated with the huge numbers of besieged and displaced people. This war represents a human tragedy of epic proportions with significant business, economic, and geopolitical considerations as we describe in this Outlook.

Forces Driving Shifts in Capital Flow

"Sweeping and indiscriminate sanctions would only make people suffer. If further escalated, they could trigger serious crises in the global economy and trade, finance, energy, food, and industrial supply chains, crippling the already languishing world economy and causing irrevocable losses."

– Excerpts from China's Ministry of Foreign Affairs statement following the President's Xi-Biden March 18th video conference call

As if fighting a global pandemic for the past two years was not enough, the world is now dealing with a ground war in Europe that has the potential to undo much of the progress made since the Berlin Wall came down in 1989. In recent years, China and Russia have been seeking a rebalancing of the global order with the desire to reduce the military and economic influence of the United States and its allies.

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The remaking of the world order and the global economy is underway, and this may be the most meaningful change the world has experienced since WWII

Autocratic nations have been spending heavily on developing their military capabilities. The sanctions recently imposed on Russia were among the most severe issued in history and have already had a devastating effect on the Russian economy as shown in Chart 1. As a result, our adversaries are considering new ways to mitigate the costs of future sanctions on their economies by establishing alternatives to existing Western-controlled systems such as SWIFT (Society for Worldwide Interbank Financial Telecommunication) banking system. The sanctions are also causing nations and companies to reorient their supply chains and currency reserves to protect their economic interests against future actions by rival nations or blocs. The remaking of the world order and the global economy is underway, and this may be the most meaningful change the world has experienced since WWII.

Chart 1. The Impact of Sanctions on the Russian Economy

The combination of energy and food inflation combined with supply shortages and stockpiling will impact the most vulnerable countries, companies, and individuals

Several forces are redefining the global economy. First, global growth will be lower than previously projected. Second, headline inflation will remain elevated as labor costs rise and energy and food supplies are being disrupted. Third, the supply chain issues, which the world has been battling since the start of the pandemic and which had been starting to ease, are now being exacerbated by the war and the sanctions imposed on Russia by allied nations. The combination of energy and food inflation combined with supply shortages and stockpiling will impact the most vulnerable countries, companies, and individuals. Fourth, policymakers will increase or shift spending to improve national defense, space, cyber, food and energy security. One additional issue that investors should consider is the intended and unintended consequences of the sanctions imposed by the West, particularly if the U.S. follows through on threats to add sanctions to China in the event that the Chinese help Russia. The Russian economy is feeling the full effects of the initial sanctions as it has been forced to raise its benchmark policy rate to 20%, while its stock market and currency have been severely damaged.

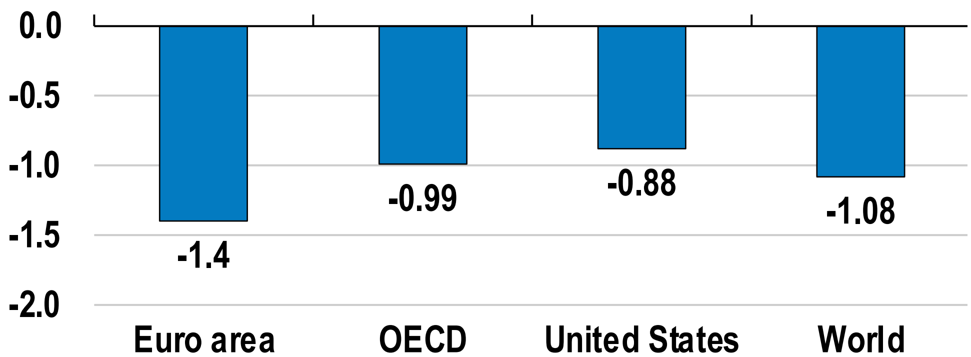
The OECD recently released an update which projected world GDP to drop by 1.09%

For the global economy, slower growth will mitigate some of the current inflationary pressures as demand declines

Lower Global Growth

Gross Domestic Product for many countries was on pace to return to pre-COVID levels by the end of this year or next, but the war makes those projections unlikely to be achieved. Prior to the invasion, global real gross domestic product was projected to grow around 3.4% due to the impact of inflation, reduced government stimulus, tighter monetary policies and ongoing supply chain issues which were only starting to be resolved. The OECD recently released an update which projected world GDP to drop by 1.09% (see Chart 2). Unfortunately, many emerging economies will be severely impacted by the combination of the lingering healthcare issues from the pandemic, high U.S. dollar-denominated debts, volatile commodity prices and availability, and erratic economic policies. For the global economy, slower growth will mitigate some of the current inflationary pressures as demand declines.

Chart 2. The War's Impact on Global Growth



Source: OECD, Economic Outlook, Interim Report March 2022

Higher Inflation

Coming into the year, ARS believed that the economy would see its deflationary tendencies return in the second half of 2022 following the supply-driven inflation experienced due to the pandemic. However, the war has added a new layer of complexity on to the inflation dynamics as Russia and Ukraine account for only 2% of GDP combined but have an outsized impact on the world's energy and food supplies. Russia, the 11th largest economy in the world, is one of the world's leading exporters of oil, natural gas, nickel, aluminum, semi-finished iron, and wheat. Europe, in particular Germany, is highly dependent on Russia for its energy needs. Europe had been aggressively shifting away from fossil fuels to renewable energy but was still early in the transition when the war broke out. The subsequent spike in oil and natural gas prices, as well as concerns about sanctions cutting off supplies to Europe, has governments scrambling to figure out ways to reduce the impact in the form of fuel subsidies, gas tax holidays, and fast-tracking

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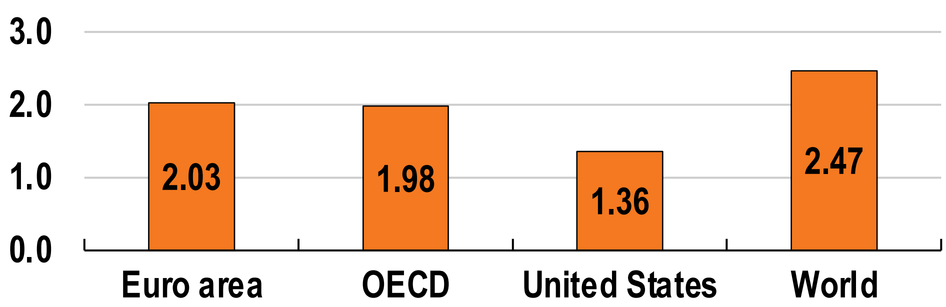
The interest rate outlook calls for higher rates as the Fed grapples with higher inflation arising from energy and food supply shortages as well as higher labor costs

There is little central banks can do to offset inflationary pressures caused by supply disruptions beyond simply trying to reduce the level of aggregate demand, as their tools are designed to address inflation that results from excess demand

permit approvals for energy companies to bring on additional production sooner. The food problem may prove to be even more difficult to address as the world may lose a substantial portion of crops if Ukrainian farmers cannot meet this season's planting deadlines. Food inflation was one of the key issues leading to the Arab Spring over a decade ago. Regardless of the actions taken by policymakers, the OECD projects that the war's impact on inflation will range from increases of 1.36% for the U.S. to 2.47% for the world (see Chart 3). While it is exceedingly difficult to make projections when the war's duration and outcome is unknown, the world has clearly entered a period of higher prices.

Chart 3. The War's Impact on Inflation



Source: OECD, Economic Outlook, Interim Report March 2022

Interest Rates to Rise, But Must Remain Historically Low

The interest rate outlook calls for higher rates for the coming period as the Fed grapples with higher inflation arising from energy and food supply shortages as well as higher labor costs. Since 2009, central bank policy has played an outsized role in supporting the markets and global economy as both struggled to recover first from the great financial crisis, then from the pandemic and now from the war. Last year, central banks began tightening policy by raising benchmark policy rates, reducing quantitative easing, and signaling the end of the most extraordinary period in monetary policy history. Central bankers are trying to balance curbing inflation by increasing rates just enough, while avoiding tipping the economy into recession. One of the challenges is that there is little central banks can do to offset inflationary pressures caused by supply disruptions beyond simply trying to reduce the level of aggregate demand, as their tools are designed to address inflation that results from excess demand.

Given the current state of the world's economy, this interest rate hiking cycle may be quite different than previous ones as much of the world's economy was still struggling to recover from the two previous crises. Based on current conditions, it is likely that many countries will experience a recession sometime over the next 24 months.

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We believe the Fed will prefer to continue to let inflation run higher than normal rather than cause a recession by hiking too aggressively. Furthermore, the Fed will likely raise rates fewer times and to levels below what the Fed and market participants currently project, as the slowing global economy will naturally reduce demand and dampen inflationary pressures. It is too soon to determine the full impact of the war on growth and inflation given the broad range of possible outcomes, and therefore, investors should expect the Fed and other central banks to be flexible in setting the course for policy actions.

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Geopolitical and Political Forces

"Sweeping and indiscriminate sanctions would only make people suffer. If further escalated, they could trigger serious crises in the global economy and trade, finance, energy, food, and industrial supply chains, crippling the already languishing world economy and causing irrevocable losses."
– Economist Adam Posen, President of the Peterson Institute

For decades, globalization has brought the world closer together and raised living standards for billions of people, but it also created vulnerabilities for many domestic economies which have been brought to light in the past two years. First the pandemic and then the war provided a painful reminder just how interconnected and interdependent the global economy had become. The pandemic and the war in Ukraine underscored the over-reliance on autocratic nations in the global system for necessary resources including food, energy, commodities, and other basic materials. The war in Europe is remaking the world order and alliances, and it is forcing world leaders to reassess their foreign and domestic policy priorities and dependencies in several key areas including national security (military, food, cyber and energy), the role of intergovernmental agencies such as NATO, WTO, and the UN, and how to properly affect the climate transition. It is also forcing policymakers to reconsider budget priorities. The severity of the sanctions placed on Russia by western governments has countries, including China, exploring ways to insulate their economies from future sanctions and to form new economic and defense alliances. The United States and virtually every nation will now be focused on building up strategic reserves in a variety of essential materials required for the advancement of alternative energy sources, and critical defense needs and technologies. The buildup of strategic reserves can increase the prices of these materials and keep them elevated for an extended period of time.

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The war will have a major impact on domestic policy agendas as well. In the United States, Congress is being forced to adjust spending priorities and policy around national security. Given the need to increase spending in certain areas, President Biden's Build Back Better agenda will likely be greatly reduced or not implemented at all.

Some experts are suggesting that globalization has ended, but it will more likely shift to blocs whereby like-minded nations work to protect people and grow their economies in a changing world order

Policymakers must address the growing cost of security due to the significant damage from climate change and the effects of war

The preservation of capital in pursuit of investment returns is both an offensive and a defensive process

Congress will likely be forced to rethink our energy policy, defense spending, and social spending priorities to deal with the new political and economic realities. For China, the war has put the nation in a difficult position as it has close political ties to Russia, but much greater economic dependency on western nations. As the world's second largest economy and largest exporter, China will play an outsized role in how the political and economic issues get resolved. Europe will be facing several new challenges involving energy, defense, immigration, and resources while working to avoid a severe recession. Some experts are suggesting that globalization has ended, but it will more likely shift to blocs whereby like-minded nations work to protect people and grow their economies in a changing world order.

Investment Opportunities for a Changing World

"The availability of ever-cheaper goods like cars, appliances and furniture produced abroad was a major contributor to the benign U.S. inflation picture in this quarter-century. On the other hand, offshoring also led to the elimination of millions of U.S. jobs, the hollowing out of the manufacturing regions and middle class of our country, and most likely the weakening of private-sector labor unions. The recognition of these negative aspects of globalization has now caused the pendulum to swing back toward local sourcing. Rather than the cheapest, easiest and greenest sources, there'll probably be more of a premium put on the safest and surest."
– Howard Marks, Oaktree Capital

Portfolio management is both an art and a science. It is a decision-making process that requires sifting through enormous amounts of incomplete information and making a judgment as to what is really important. This is particularly true not only in a period of heightened uncertainty, conflict, and volatility such as we are in now, but also when the world is undergoing a fundamental change that is impacting virtually every industry. Policymakers must address the growing cost of security due to the significant damage from climate change and the effects of war. For much of the past decade, market participants had the wind at their backs and were able to be more aggressive than in normal times. This was due to historically low interest and inflation rates which supported higher price-earnings multiples for companies with the promise of strong future growth, but the reality of little or no current earnings. In a rising interest rate environment such as we are in today, price-earnings multiples have been and are contracting, and valuations are coming down. While we did not anticipate rates to rise as much as they have this year, we were, for some time, of the belief that multiples would contract for those companies with elevated valuations and little if any current earnings. As a consequence, in late 2020, we began to reduce positions and completely eliminate those companies whose valuations we felt were not sustainable. We did this because the preservation of capital in pursuit of investment returns is both an offensive and a defensive process.

The dramatic shifts now taking place in the global economy will have profound implications for every country, company, and household, and these shifts are creating new investment opportunities, while reinforcing some previous ones. There are two important factors to consider for portfolio positioning: first, the need for nations to reshore and expand onshore manufacturing capabilities critical to ensuring economic and national security, and second, the need to build up strategic reserves to protect future supplies of required resources. Whereas just in-time inventory management had been considered an ideal way to manage manufacturing processes in the past, the pandemic and war have made "safe and sure" supplies in needed materials the priority over cost savings. Advanced technologies will also allow companies to offset the former attraction of lower foreign manufacturing costs thereby creating many new jobs at home.

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Aside from the opportunities described above, the focus for client portfolios remains consistent with our recent Outlooks as we continue to favor the beneficiaries of the digitalization and electrification involving cloud, cyber security, communications, semiconductor technology, industrials, healthcare, energy companies including wind and power, and commodity and materials producers. Investors should continue to avoid over-hyped areas of the market, but also to be opportunistic to take advantage of the mispricing of quality companies that inevitably occur in volatile markets and uncertain periods.

The pandemic and war have made "safe and sure" supplies in needed materials the priority over cost savings

We focus on the investment opportunities which meet our standards of valuation under these changed conditions. We anticipate that companies will move more aggressively to improve productivity and better compete in the coming period through merger and acquisition activity and spinoffs. Notwithstanding the significant advancements of many of the leading beneficiaries of this Outlook over the past few years, periods of market volatility should be viewed both as the pause that refreshes and an opportunity to add to quality companies with particularly attractive valuations which have significantly increased their revenues and earnings and continue to have bright prospects for strong growth. Because the economy is undergoing a reorientation, the companies with embedded advantages will continue to fetch the best market valuations over time. Security of critical raw materials is fundamental to successful investment outcomes. Continuing innovation and embracing the latest technologies will be fundamental for companies to remain at the forefront of competition.

Investors should be focused on benefiting from the powerful secular trends and not on speculating in shares of companies whose futures are behind them

Regardless, a number of leading companies, large and small, will continue to innovate, disrupt, and evolve their business models to thrive in the coming years. As such, investors should be focused on benefiting from the powerful secular trends and not on speculating in shares of companies whose futures are behind them as they have either lost their way or will be unable to transition in their current forms to benefit going forward.

ARS is pleased to announce that Greg Kops has joined the firm as a Portfolio Manager. With 15 years of industry experience, Greg joined ARS from Morgan Stanley. Please join us in welcoming Greg to the team.

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