ARS INVESTMENT PARTNERS

THE OUTLOOK

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The shift from QE to QT is going to be painful and will require investors to rethink asset allocation and security selection.

The current environment is presenting many risks, but also opportunities

Opportunities - Quality and Innovation on Sale

While a deep recession is not our base case, investors should proceed with caution given the variability of outcomes and the possibility of a major policy miscalculation.

At the same time, the recent market pullback now has any number of the highest-quality businesses selling at valuations typically available only during periods of severe economic stress.

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Disruptions and Opportunities

"Russia's invasion of Ukraine has dealt a blow to the global economy – weakening the post-pandemic recovery and aggravating already high inflation. Even if the worst fears of rising geopolitical tensions and larger economic disruptions do not materialize, private forecasters anticipate an inflationary slump for the world economy… The war's economic damage will partly depend on the persistence of high inflation and economic "scarring" over the medium to long term."

– Excerpt from Dallas Federal Reserve Bank, May 17, 2022

The global economy is facing a series of destabilizing shocks intensified by the Russian invasion of Ukraine. In addition to creating a tragic humanitarian crisis, the war is disrupting global supply chains, food, energy, trade, and geopolitics. While the current environment bears some resemblance to past periods such as the 1970s, it also has several distinctive characteristics. As we said in our last Outlook, the world has changed as the global economy and markets are undergoing a series of critical transformations. Prior to the Russian invasion of Ukraine, some countries were returning to pre-pandemic economic activity, but many other countries were facing severe economic, social, and political challenges which the war has only exacerbated. As the duration and severity of the war in Ukraine remains highly uncertain, the potential risks to the downside have market participants and policymakers worrying about an inflationary slump and possibly a deep recession for the world economy. While a deep recession is not our base case, investors should proceed with caution given the variability of outcomes and the possibility of a major policy miscalculation. At the same time, the recent market pullback now has any number of the highest-quality businesses selling at valuations typically available only during periods of severe economic stress.

For much of the past decade investors across asset classes have benefited from the most aggressive monetary and fiscal policy regimes in history that had been appropriate for the circumstances at that time, but no longer exist today. Presently, central banks around the world have been forced to shift from a highly accommodative policy to a restrictive policy to counter a rapid increase in inflationary pressures much of which began on February 24th with the invasion of Ukraine. Concurrently, governments are facing several significant budgetary constraints in the face of many necessary big-dollar investment programs including the green energy transition, strengthening

and reorienting supply chains, fixing aging infrastructure, and enhancing national security, among others. After kicking the can down the road for decades on many critical investments which can no longer be postponed, the bill has now come due, and it could not have happened at a worse time for many politicians. The combination of the lingering effects of the pandemic and the invasion of Ukraine by Russia is undoing much of the work done by policymakers since 2008 as rising inflation and slowing growth are damaging consumer and business confidence. For politicians, it will be exceedingly difficult to do the right (and likely unpopular) thing to address the multitude of problems and still get re-elected. Meanwhile, there is growing dissatisfaction among voters around the world which is forcing politicians to be even more short-term oriented which will make enacting effective legislation even more difficult.

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One key to a solid investment strategy is to invest in the beneficiaries of the problems. The secular trends we have identified in recent Outlooks will continue to be fundamental to improving the economy and living standards, but there will be a time lag between the future benefits and current conditions as reflected in the stock prices of the beneficiaries. Just to remind our readers, the trends are in digitalization, electrification, lowering healthcare costs, productivity improvements and the need to enhance national security. The equity markets, both public and private, are dealing with an unknown outcome of the war and COVID related disruptions and cannot value with any certainty these circumstances. This uncertainty, combined with tightening of financial conditions, suggests further contraction in price/earnings multiples followed by earnings declines which are likely to persist until inflation levels off and interest rates stabilize or decline. Those investors with the knowledge, experience, and conviction to look beyond the immediate period will be able to recognize rare buying opportunities. Accordingly, we have been taking advantage of the choices available to initiate positions in some of these companies or to add to existing positions in client portfolios.

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From QE to QT

"The Committee is acutely aware that high inflation imposes significant hardship, especially on those least able to meet the higher costs of essentials. The Committee's commitment to restoring price stability— which is necessary for sustaining a strong labor market—is unconditional."

– Federal Reserve Monetary Policy Report, June 17, 2022

The above statement from the Federal Reserve's Monetary Policy Report highlights one of the major transformations occurring today as the Fed transitions from trying to stimulate the economy to trying to manage a tightening of conditions to bring inflation back down and avoid a recession.

In addition to the Fed, most major central banks, with the exception of the Bank of Japan and the Peoples Bank of China, are tightening financial conditions aggressively to counter inflationary pressures. The Federal Reserve Bank of Dallas recently produced a paper which illustrates how the outlook for growth and inflation has shifted since the start of the war. In the Dallas Fed's report, global growth projections (Chart 1) declined by 1% for 2022 and 0.3% for 2023 since February 18th, while the CPI inflation forecast for 2022 increased by 2.3% and by 1% for 2023. What a difference a few months made in the forecast.

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Chart 1. Weakening Global Growth, Higher Inflation

Source: Consensus, Economics: authors' calculations.

Among the biggest challenges for the Fed and other central banks are the high degree of uncertainty which must be factored into their decisions and the limitations for future policy maneuvers. The outlook for inflation will depend on several factors including the COVID-19 lockdowns in China, how and when the invasion of Ukraine ends, potential strikes this summer of workers at the Ports of L.A. and Long Beach as well as railroad workers, and labor costs where worker shortages will command higher wages to compensate. These factors could lead to more persistent inflation for certain parts of the economy leaving the Fed in the position of raising rates beyond market expectations. Again, this is not our base case as we expect the Fed to respond to slowing growth by backing off on the number of expected rate hikes as inflationary pressures ease. Regardless of when inflation peaks, the result for consumers and corporations will be higher prices than before the pandemic and the war.

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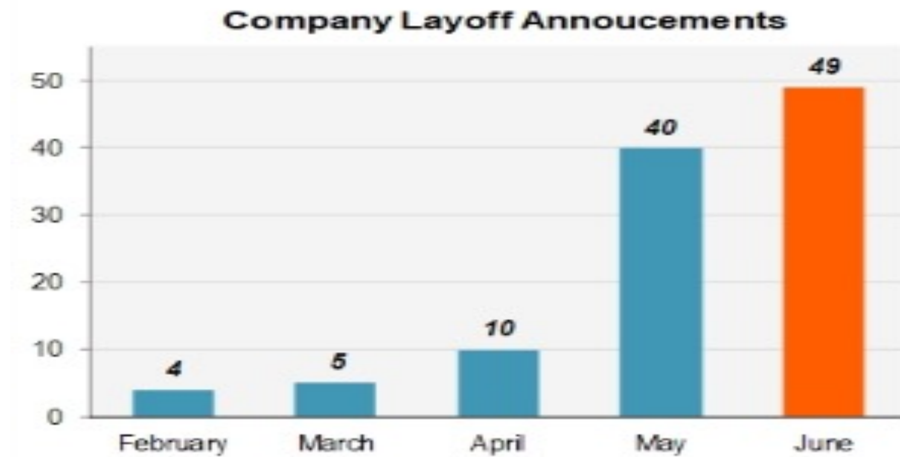
Chart 2. Signs Wage Pressures May Be Easing



Source: Piper Sandler, Marco Economic Research, July 2, 2022

A strong dollar will slow U.S. export activity which will slow global growth even further. As business and consumer confidence declines, behavioral changes in the form of reduced spending typically follows, which should support an easing of inflationary pressures.

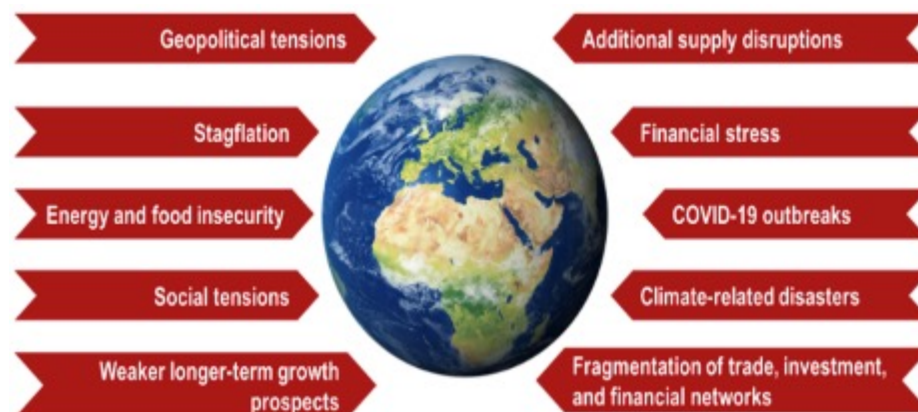
We have already seen a pickup in layoff announcements (Chart 2) as well as hiring freezes which should ease wage pressures in some industries and slow growth, reducing the need for central banks to tighten as aggressively as currently expected and may even require a policy reversal later in 2022 or 2023. However, as we have seen in many industries, there are still shortages of skilled labor which will take time and policy changes to moderate. As we mentioned in our April Outlook, "*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.*" For example, a strong dollar will slow U.S. export activity which will slow global growth even further. As business and consumer confidence declines, behavioral changes in the form of reduced spending typically follows, which should support an easing of inflationary pressures.

Risks and Global Economic Prospects

"The outlook is subject to various downside risks, including intensifying geopolitical tensions, growing stagflationary headwinds, rising financial instability, continuing supply strains, and worsening food insecurity. These risks underscore the importance of a forceful policy response. The global community needs to ramp up efforts to mitigate humanitarian crises caused by the war in Ukraine and conflict elsewhere, alleviate food insecurity, and expand vaccine access to ensure a durable end of the pandemic."

– Excerpt from the World Bank Global Economic Prospects Report, June 2022

Chart 3. Rising Risks to Global Systems



Source: World Bank, Global Economic Prospects, June 2022

Climate-related disasters are increasing in both frequency and severity, while the clean energy transformation is not progressing as hoped and will require far greater reliance on fossil fuels to power the world for longer than originally planned to effect the transition.

The problems are many, but innovation is one of the keys and the reason the battle for technological supremacy between the United States and China has grown so intense.

In its most recent Global Economics Prospects Report, the World Bank highlighted several risks facing the world today and these risks are highlighted in Chart 3. The world is facing rising risks of an increase in geopolitical tensions as the U.S. Department of Defense recently identified Russia and China as the primary threats with North Korea, Iran, and terrorist states representing other main concerns. The war has layered on additional problems for the global supply chain system as nations are scrambling to ensure that they can access dependable and secure supplies of materials necessary for national security (including food, energy, cyber and military) through re-shoring (bringing manufacturing back home), onshoring (bringing in new production capabilities), or “friend shoring” (running supply chains only through countries that are close political partners) which Treasury Secretary Janet Yellen has discussed recently. The world continues to work to arrest the COVID-19 pandemic, but much more needs to be done there even before we start to address potential future pandemics. Higher inflation coupled with weaker long-term growth prospects will create added stress on societies and greater demands for government support at a time where government finances are stressed.

Concurrently, climate-related disasters are increasing in both frequency and severity, while the clean energy transformation is not progressing as hoped and will require far greater reliance on fossil fuels to power the world for longer than originally planned to effect the transition. The problems are many, but innovation is one of the keys and the reason the battle for technological supremacy between the United States and China has grown so intense. Perhaps the greatest area of concern is the intensification of geopolitical tensions which could further disrupt economic activity, increase policy uncertainty, and potentially lead to a significant fragmentation as nations form blocs with like-minded nations for economic and security purposes.

Opportunities – Quality and Innovation on Sale

"For long-term investors, it will prove beneficial over time that markets are exiting an artificial regime that was maintained for far too long by the Fed and that resulted in frothy valuations, relative price distortions, resource misallocations and investors losing sight of corporate and sovereign fundamentals. The promise now is one of a more sustainable destination. Unfortunately, it comes with an uncomfortably bumpy and unsettling journey."
– Mohamad El-Erian, Bloomberg, July 5, 2022

Notwithstanding relief rallies due to periodically oversold conditions, markets will likely continue to struggle to find firmer footing until inflation and Treasury yields begin to peak. For investors, the current conditions are resulting in a significant reset of valuations across asset classes to reflect a vastly different monetary and fiscal policy regime from that of just a few quarters ago. The reset has been painful as the NASDAQ has lost over 30% from its recent high, cryptocurrency Bitcoin is down from a high of over $66,000 to around $20,000, the big mega cap tech stocks are down anywhere from 25-75%, mortgage rates have spiked up from 3.25% to almost 6%, and the S&P 500 has fallen into bear market territory. For ARS clients, it is important to keep in mind that the secular trends we have identified in recent Outlooks will continue to be fundamental to an improving economy. We remain focused on the beneficiaries of the trends in electrification, digitalization, lowering healthcare costs, and those delivering on the need to enhance national security (food, energy, cyber, and military) at home and abroad. There will be a time lag between the future benefit as reflected in the stock prices of the beneficiaries and the present economic pressures weighing on the markets overall.

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There will be a time lag between the future benefit as reflected in the stock prices of the beneficiaries and the present economic pressures weighing on the markets overall.*

Excessive focus on near-term concerns distracts from the subset of companies that stand to benefit from the current environment, especially those experiencing pricing power and inelasticity of demand for their products. An important fundamental concept for investors to understand at this time is that price inelasticity reflects goods and services that typically tend to have few substitutes, few competitors, and are considered necessities by users. Given the ongoing supply-chain woes, inflationary pressures, and a strong dollar, the ability of companies to offset any increase in production costs will enable them to increase earnings and cash flow from operations and should be worth more over time. Among the areas of investment opportunity are semiconductor chips and equipment, cloud providers, select commodities producers including steel, rare earth materials, chemicals, copper, and even some fossil fuel producers as each should continue to see strong pricing power, demand, and earnings growth. In addition, our research has identified a number of public companies which have announced significant, multi-year stock buyback programs of 15-20% of their outstanding

The winners will be those companies whose product demand is inelastic as those will continue to have better pricing power.

While the natural tendency during times of economic stress is to shift to a more conservative approach, we believe that this will only work as a short-term decision as well-selected equities will be the only way to offset higher living costs over time.

The best investments are presented when the markets are under extreme pressure and most market participants are not emotionally able to act to take advantage of exceptional circumstances.

shares annually with an eye toward potentially taking their companies private over time. These companies have the financial strength to thrive against their competitors in this particularly challenging environment.

There is a growing separation between the corporate haves and have-nots making security selection the most important it has been in a long time. The shift from near-zero interest rates will require portfolio managers to be much more selective to invest in those companies that benefit from this policy regime change. The winners will be those companies whose product demand is inelastic as those will continue to have better pricing power – an important theme that we touched on in prior Outlooks – as well as those with strong balance sheets which allow for continued investment, merger and acquisition activity, increased buybacks, and – importantly – growing dividend payments. Due to surging inflation, higher input costs, and a strong dollar, market participants should expect analyst estimates to be reduced when companies report second quarter earnings as more corporate executives are likely to announce lower guidance, and in some cases, withhold guidance completely.

At some point, inflation will ease. The result will be a higher level of interest rates than before the war and a higher cost of living. Considering that the dollar has lost around 83% of its purchasing power since 1974, asset class and security selection need to protect purchasing power even more effectively than at any time in the last 50 years. While the natural tendency during times of economic stress is to shift to a more conservative approach such as increasing fixed income exposure, we believe that this will only work as a short-term decision as well-selected equities will be the only way to offset higher living costs over time. In addition, the current conditions suggest that market winners will be a narrow subset of the overall market whereas for much of the past decade it was more beneficial to own the entire market. In the current economic environment, indexing will capture both the winners and the losers, something we and most investors will find unsatisfactory. This is a time for focused and targeted security selection regardless of whether you are in the public or private markets. Many companies are on the lookout to purchase undervalued companies to enhance their competitive positions and business prospects. Given the amount of liquidity still present in the global system and the excess cash flow being generated by many corporations, the window of opportunity for investors in these mispriced companies may not be available for long. As great investors know, the best investments are presented when the markets are under extreme pressure and most market participants are not emotionally able to act to take advantage of exceptional circumstances.

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Please join us August 2nd for "What Matters Now: Too Much Pessimism or Not Enough?" with Dr. Ed Yardeni

The US economy seems to be heading into a recession, while inflation remains high. The S&P 500 has given back all its gains since the start of 2021. It's hard to be an optimist under the circumstances. Indeed, one measure of consumer sentiment is the lowest on record starting in 1952. Investors Intelligence Bull/Bear Ratio is the lowest it has been since the bottom of the bear market during the Great Financial Crisis. Might there be too much pessimism? The past year has been like living through the stagflationary 1970s, but on fast forward. However, a mild recession could help to bring inflation down sooner rather than later, setting the stage for a recovery with gains to be had again in the bond and stock market. Dr. Ed Yardeni will provide a balanced discussion of what could go right and what could go wrong over the rest of this year, as well as the rest of this decade.

Published by the ARS Investment Policy Committee: Stephen Burke, Sean Lawless, Nitin Sacheti, Andrew Schmeidler, Arnold Schmeidler, P. Ross Taylor.

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