ARS INVESTMENT PARTNERS

THE OUTLOOK

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Inflation, The Dollar, and The End of Ultra-Easy Money

The decade-long party involving ultra-easy fiscal and monetary policies has come to an end as concurrent food, energy, security, and cost of living crises are reshaping our world. The days of the Fed rescuing markets are over and have been replaced by policymakers working to rapidly tighten economic conditions to bring down inflation. As a result, the world and the U.S. monetary regimes are returning to a more normalized interest rate environment after an extended period of negative and zero interest rates. Valuations are undergoing the most meaningful re-adjustment process since the Great Financial Crisis to reflect current interest rates and inflation rates. Under present conditions, the global economy will likely experience a recession in the coming quarters with Europe and China among the greatest areas of financial stress. The U.S. remains the most attractive developed market economy and a magnet for capital flows from the rest of the world, but its economy will be challenged as well. The pandemic, its accompanying supply chain problems, and Russia's attack on Ukraine continues to remake our world and accelerate the rate of change for so many aspects of society. It remains unclear just how much things will change as we still do not know how everything sorts out. Nevertheless, what is clear is that the global economy is experiencing more persistent cost pressures and reduced economic activity while policymakers have less bandwidth to support their economies than they have had in the past. Therefore, the adjustment process will be painful for the most vulnerable governments, companies, and individuals.

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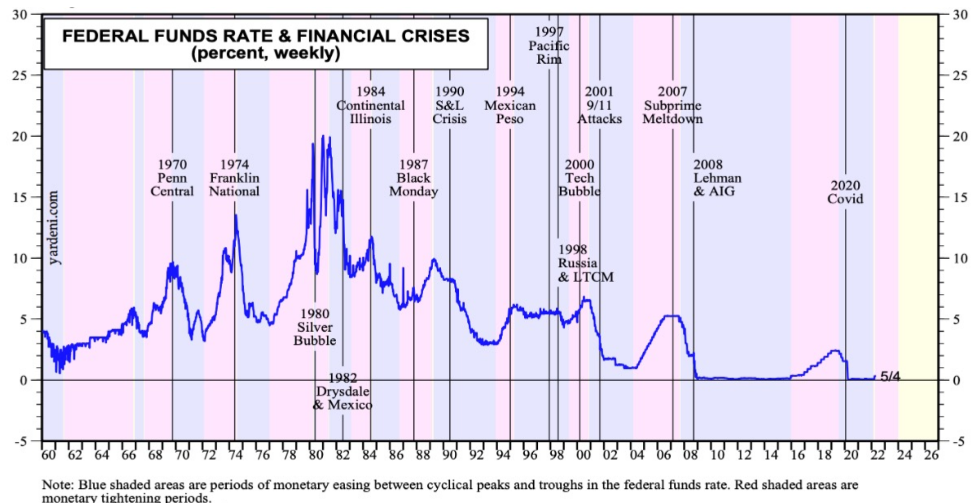
Chart 1. When the Fed Tightens, Financial Cries Usually Follows



Sources: Federal Reserve Board, Yardeni Research, Inc

To bring inflation down, the Fed is targeting both the real economy and as a result the asset markets which means slower growth, higher unemployment, and lower asset values

The pullback in the global equity markets has created an attractive opportunity to selectively purchase some of the world's leading businesses at much more favorable valuations than just a few quarters ago

Gone are the easy-money days of zero and negative interest rates, and these have been replaced by a rapid tightening of global financial conditions

In our April Outlook titled "Everything's Changed," we wrote that the global economy would experience trade shocks, financial turbulence, flows of capital, and the flight of refugees. At that time, we felt that the global economy would experience higher levels of inflation which would lead to slower global growth. Unfortunately, all these concerns have come to pass which has raised the probability of a global recession. Historically, when the Federal Reserve begins a cycle of interest rate increases, it causes financial stress in other parts of the world as seen in Chart 1 and investors should anticipate that this tightening cycle will probably cause a problem in one or more economies. Since March of 2009 when then Federal Reserve Chair Ben Bernanke announced the initial quantitative easing program, investors have relied on central banks and fiscal initiatives to provide support to the economy, equity, and bond markets. As a result, investors were able to be much more aggressive and much less disciplined, while seeing equity and bond markets rally significantly as the policy support provided was massive and unprecedented. Today, market participants are facing a market environment characterized by increased uncertainty and volatility as the previously favorable conditions driving returns have been and continue to be in the process of being reversed. To bring inflation down, the Fed is targeting both the real economy and as a result the asset markets which means slower growth, higher unemployment, and lower asset values. Market participants who have grown accustomed to strong returns across asset classes must now recognize that we have entered a new economic period where assets are being revalued and different investment opportunities are presented. Notwithstanding the obvious challenges in the world today, the pullback in the global equity markets has created an attractive opportunity to selectively purchase some of the world's leading businesses at much more favorable valuations than just a few quarters ago.

The End of the Easy Money Era and the Strengths of the U.S. Dollar

Since the start of the pandemic, central banks and fiscal authorities have committed more than 35% of global GDP or over $30 trillion in stimulus to combat the virus. That along with the food and energy inflation stemming from the Russian invasion of Ukraine has forced monetary and fiscal authorities to reverse course shifting from easy money policies to restrictive policy to bring inflation under control. Gone are the easy-money days of zero and negative interest rates, and these have been replaced by a rapid tightening of global financial conditions. The Federal Reserve has raised the fed funds rate from 0.0-0.25% to 3.25% within the last seven months with plans to move to an estimated 4-5% level. In the U.S., mortgage rates have risen from around 3.5% to 7% creating a material change in housing market dynamics. Global short-term interest rates have risen from near 0.5% to over 3.5% as there have been more than 180 rate increases by central banks over the last 18 months. After having pumped $120 billion per month into the system, the Fed has started to reduce its balance sheet by $95 billion per

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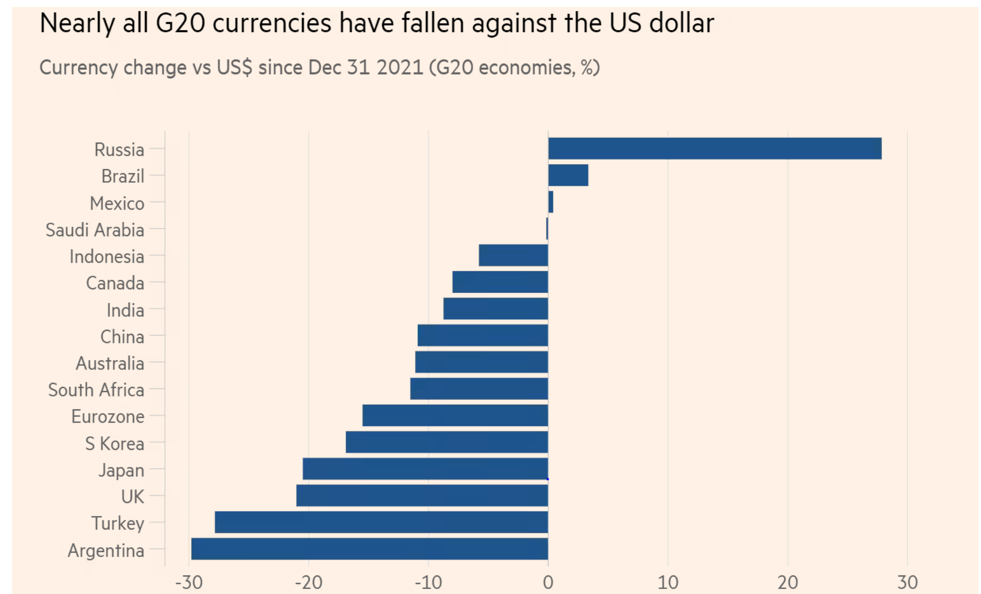
month. The combination of these actions has tightened financial conditions with the outcome theoretical as we have never had a reversal of quantitative easing of this magnitude, so no one really knows how this will end as it is all based on monetary modeling.

Chart 2. The U.S. Dollar Strength



Source: Refinitiv

Importantly, the strength of the U.S. dollar means that the United States is now importing deflation and exporting inflation as commodities and other products are priced and traded in U.S. dollars

One area where we are seeing the financial dislocations is in currency markets as the multi-decade strength of the U.S. dollar is wreaking havoc on other nations and their respective currencies (see chart 2). Importantly, the strength of the U.S. dollar means that the United States is now importing deflation and exporting inflation as commodities and other products are priced and traded in U.S. dollars (as shown in Chart 3). This is important in bringing down inflation in the United States as the U.S. currently imports $4.065 trillion per year and exports $2.98 trillion per year. The strong dollar also raises the debt servicing cost for foreign countries holding dollar-denominated debt and is placing further strains on the most vulnerable nations in the emerging markets.

The aggressive moves by the fed to hike interest rates are causing disruptions in the currency markets as the U.S. dollar plays an outsized role in the global economy

Chart 3. The U.S. Dollar's Importance

Sources: The Global Dollar Cycle, Obstfeld and Zhou, Aug 2022

There are three key implications of the end of the easy-money era. First, many governments now find themselves facing rising deficits, higher debt servicing costs, and growing social strains. When the history of this period is written, many governments will be criticized for wasting a significant opportunity to use zero-interest rates to invest in the structural changes needed to put their economies on a path to sustainable growth. Instead, governments focused on short-term benefits and are now left with big spending needs, but without the resources to stimulate economic activity with a global recession looming. Second, the aggressive moves by the fed to hike interest rates are causing disruptions in the currency markets as the U.S. dollar plays an outsized role in the global economy impacting commodities, global trade, global payments, foreign exchange transactions, foreign dollar-denominated debts, and reserves. This is leading to "reverse currency wars" whereby countries are trying to strengthen their respective currencies to offset inflationary pressures brought about by the strong U.S. dollar as most commodities trade in dollars. Third, the sudden shift from easy money policies to tightening policies means that valuations are being reset to reflect a return to classic levels of inflation rates, interest rates and equity valuations.

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Investing in Secular Themes

Notwithstanding the pressures described, there are five secular themes which should attract capital in the coming period. These themes are the electrification of the world, digitalization to improve productivity and offset demographic challenges, national security around food, energy, cyber and military security, biotechnology that will lower the cost of healthcare in the U.S., and special situation opportunities. Many of these are identified by governments and businesses as areas of mandatory future spending.

ELECTRIFICATION – ARS is investing in this theme in three ways. First, through old energy companies by owning independent oil and gas exploration and production/marketing companies which are typically selling at significant discounts to the market P/E multiples, but their renewed financial discipline and reduction of trusted energy sources for the world's needs will make these companies even more valuable. Many are allocating more than 50% of free cash flow to be paid out to shareholders through dividends. Second, we are investing in industrial solar plays including one company that is a global provider of utility-scale solar installations and another that is a key global supply chain and manufacturing solutions provider. Finally, we are investing in the shift to EVs (electric vehicles) from ICEs (internal combustion engines). We are investing in two industrial companies that provide the rare earth materials and copper which are essential in EV production, and American multinational car manufacturers committed to expanding their EV fleets.

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DIGITALIZATION – The world is facing major challenges of rising inflation and worsening demographics. Technology holds one of the keys to combating these two issues, and it still has a long runway for investors. ARS is investing in the major players in cloud computing, semiconductor chips, cyber security, and companies that improve power and efficiency. In addition, labor supply and costs are pushing more companies to use robotics and automation to improve efficiency, offset wage pressures, and as a substitute in jobs lacking qualified candidates.

NATIONAL SECURITY - In response to recent setbacks on the battlefield in Ukraine, Mr. Putin has doubled down on his aggressive behavior by attacking civilian targets and critical infrastructure while threatening the use of tactical nuclear weapons. The war in Europe was a wake-up call for government leaders, especially those of NATO members, to properly supply their armed forces with state-of-the-art equipment. We expect military spending to increase among NATO members and their adversaries in the coming decade.

The benefits of digitalization are being realized in healthcare, and the pandemic illustrated this with the research and development of new vaccines and medicines in record time

LOWER HEALTHCARE COSTS – The use of artificial intelligence to analyze data has led to exciting developments in healthcare. This is leading to an accelerating pipeline and the introduction of new drugs, therapies, and breakthrough medical technology. The benefits of digitalization are being realized in healthcare, and the pandemic illustrated this with the research and development of new vaccines and medicines in record time. The prospect of better healthcare enabling longer lives leads to greater productivity.

SPECIAL SITUATION OPPORTUNITIES – There are three types of companies that fall into this category. The first is companies with strong and growing free cash flows (FCF) which enable them to invest in future growth ahead of their peers. The second is businesses whose financial positions are so strong that they can use their free cash flows to buy back significant amounts of their outstanding stock over multiple years as well as increasing dividends; ARS currently owns at least four companies with announced plans to buy back 15-25% of their outstanding stock annually. The third is companies that will use mergers, acquisitions and divestitures to enhance shareholder value.

As the global economy is experiencing the most significant inflationary pressure in over 40 years, it is something most investors today have not experienced

Investment Considerations

Conducting securities research and determining individual security selection is a fascinating, challenging and intellectually stimulating profession. Ferreting out opportunities is like solving a complex puzzle. Some economic conditions are easier to describe, and some have more moving parts which reflect different levels of complexity with the final conclusion always being a probability rather than a certainty. It is in times like these that managers should balance protecting the downside with taking advantage of opportunities being presented. As the U.S. and global economy are experiencing the most significant inflationary pressure in over 40 years, it is something most investors today have not experienced. The ARS 8-person investment policy committee averages over 30 years in the industry which gives us perspectives and experience in various markets that many firms simply do not have. That experience combined with our investment process discipline which marries our macro-economic analysis (top-down) and fundamental company research (bottom-up) have allowed us to deliver distinct portfolios for clients. Investment process discipline means we know what we own in client portfolios, why we own each business and what our future expectations are for the business as we have done for over 50 years. This process 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. While our strategies may be out of step with the market for brief periods as we were last quarter, we remain confident that the beneficiaries of the secular themes we have identified will generate attractive returns over time. The shift from near-zero interest rates will require market participants to be much more selective among companies that will benefit from these changing conditions. Due to surging inflation, higher input costs, and a strong dollar, market participants should expect analyst estimates to be reduced when companies report third quarter earnings as more corporate executives are likely to announce lower earnings guidance, and in some cases, withhold guidance completely.

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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, but 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. In our view, the best investment approach continues to be a focus on the beneficiaries of the conditions described in this Outlook rather than to try to time the market before committing capital. The fallout from global trade tensions, population displacements, the COVID-19 pandemic, and the war in Ukraine has forced governments and businesses to adapt to changing economic conditions and societal tensions. The global system is undergoing massive transformations due to the current political, social, economic, and climate conditions. Past experience has shown that it is in a time like this that the best investment opportunities are often missed because of excessive focus on heightened uncertainty. Uncertainty creates opportunity.

It is with mixed emotions that we announce the retirement of our friend and colleague Michael Schaenen after a 62-year career in the investment business. Michael was integral in the formation of ARS Investments Partners; he founded Schaenen Wood & Associates which later became Somerset Capital Advisors, a key company in our 2016 merger. Michael has been a mentor and trusted partner to many of us in the organization. He is highly respected by all of us. We will miss Michael's wonderful sense of humor, his sharp mind, and common-sense approach to life and business. We wish Michael and his wife Pamela all the best in their new chapter and endeavors.

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

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