THE OUTLOOK

January 12, 2023

IN THIS ISSUE…

With a World in Transition, New Opportunities Emerge

"This battle cannot be frozen or postponed. It cannot be ignored. This struggle will define in what world our children and grandchildren will live."
-Ukraine President Volodymyr Zelensky in 12/20/22 speech to U.S. Congress

For more than 5 decades we have written our Outlooks to serve two purposes: (1) to represent our roadmap for our investment security selections and (2) to inform our clients and prospects of our thinking. Our Outlooks reflect our view of the world and our investment approach to manage risk, capitalize on opportunities, and generate strong returns for our clients. Economic conditions determine interest rates, inflation rates, and corporate profits which in turn determine the valuations of common stocks. Therefore, a key focus of ours is to identify companies that are well-positioned to capitalize on and benefit from major forces and disruptions in the system. The world is at an historic inflection point with broad economic, geopolitical, and social implications as President Zelensky's quote describes. Global economic activity is experiencing a sharper-than-expected slowdown with inflation at levels we have not seen in decades, and this is occurring at a time when governments are facing shared challenges with other nations including national security, food and energy crises, and climate change, to name a few.

The re-orientation of global supply chains are promoting a shift in manufacturing closer to home. This is a fundamental change and a major boost for the United States.

We see three key changes occurring and they will require investors to re-assess their investment strategies. The three key shifts are the cost-of-living increase, the realignment of the global geopolitical order, and the re-industrialization of the global economy. The magnitude and suddenness of these changes has led to a re-rating of valuations across asset classes for most of this past year. For market participants, the biggest adjustment for investors in the coming quarters will be adapting to a less stable geopolitical environment with higher living costs and the possibility of a global recession. At the same time, the re-orientation of global supply chains and the advent of digital process automation are promoting a shift in manufacturing and production closer to home. This is a fundamental change for the global economy and a major boost for the United States. While the challenges are great, innovation continues to accelerate and will change virtually every sector and industry. Major economic shifts, such as the one occurring today, typically create new market leadership as shown in Chart 1.

The United States stands as the strongest and best-positioned economy and it's reasonable to expect a significant increase in capital flows to the U.S.

Chart 1. S&P 500 LEADERSHIP OVER THE DECADES

1990	2000	2010	2020
Exxon Mobil	Microsoft	Exxon Mobile	Apple
IBM	General Electric	Microsoft	Microsoft
General Electric	Cisco Systems	Walmart	Alphabet
AT&T	Walmart	Alphabet	Amazon
Altria Group	Intel	Apple	Meta
Merck	Nokia of America Corp	Procter & Gamble	Berkshire Hathaway
BP Corp N.A.	Pizer	Johnson & Johnson	JP Morgan
E.I. du Pont de Nemours	Exxon Mobile	JP Morgan	Visa
Motors Liquidation (old GM)	IBM	IBM	Johnson & Johnson
BellSouth	Citigroup	AT&T	Walmart

Source: Bloomberg

Beneficiaries will be companies whose fortunes are augmented by recently passed major legislation for the broad infrastructure needs of the U.S., reshoring of manufacturing and leading-edge semiconductor technologies, and national defense.

The United States stands as the strongest and best-positioned economy, and it's reasonable to expect a significant increase in capital flows to the U.S. While it is easy to see a recession hitting the United States, any recession experienced at home will have a very different character than previous ones due to the enactment of several recent major legislative changes and the shifting of industrial activity to North America. Regardless of the degree of any recession the U.S. may experience, our team continues to identify businesses selling at attractive valuations with strong balance sheets and above-market growth rates which, in our opinion, are not yet being properly recognized.

The recent zero-interest rate environment favored passive and index investing which led the market to overvalue growth companies with little to no earnings. The increase in interest rates has continued to force a reset of valuations. As a result, 2023 will continue to be a stock-picker's market where the most likely beneficiaries will be companies whose fortunes are augmented by recently passed major legislation for the broad infrastructure needs of the U.S., reshoring of manufacturing and leading-edge semiconductor technologies, and national defense. In addition, the worsening demographics of the world population are putting greater stress on governments to reduce healthcare costs and improve outcomes particularly through the application of advanced biotechnologies. We are particularly positive on the beneficiaries of this outlook despite the overall negative sentiment which is so pervasive today.

Cost-of-Living Increase

"Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures… The war and related events are contributing to upward pressure on inflation and are weighing on global economic activity."

- Federal Reserve FOMC Statement, December 14, 2022

Investors should be careful shifting to fixed income securities with longer-term maturities and should instead focus on the highest quality equities, and those that pay strong and growing dividends to protect their purchasing power.

With the dramatic increase in the cost of living, the Fed is committed to bringing inflation down to the 2% goal it continues to articulate. The last inflation statistic was 7.1%. We continue to see wages rise through legislated minimum wage increases, an 8.7% social security adjustment, labor contracts that compensate for inflation, a shortage of skilled labor and now the reshoring and investment costs of the American manufacturing supply chain. The Fed will likely, over time, move away from it's 2% inflation goal. The increase in both buying power and U.S. economic activity now being firmly established suggests that the Fed will have to raise its 2% target. Therefore, the purchasing power of the U.S. dollar will erode more rapidly, and investors should be careful shifting to fixed income securities with longer-term maturities and should instead focus on the highest quality equities, and those that pay strong and growing dividends to protect their purchasing power.

Global Fragmentation: The World at an Inflection Point

"The international community is facing changes defining an era. We are reminded once again that globalization and interdependence alone cannot serve as a guarantor for peace and development across the globe. The free, open, and stable international order, which expanded worldwide in the post-Cold War era, is now at stake with serious challenges amidst historical changes in power balances and intensifying geopolitical competitions. Today we are in an era where confrontation and cooperation are intricately intertwined in international relations."

- Japan's Ministry of Defense National Security Strategy, December 2022

The potential doubling of Japan's defense spending is particularly interesting since it has had a more pacifist approach since WWII.

The existing world order is being redefined due to the unusual events of the past few years, intensifying geopolitical competition in the international community. As a result, leaders of each country are being forced to rethink existing trade and security relationships. NATO nations have a target of 2% of Gross Domestic Product (GDP) for defense spending, but many members are now only starting to fund to that level. In October, the U.S. issued its updated National Security Strategy, followed by Japan issuing its report in December. Both are calling for significant increases in spending for defense with Japan targeting to double its spending. Japan is particularly interesting since it has had a more pacifist approach since WWII, but it is one of a handful of critical partners to help challenge China's ambitions in the Asia-Pacific region.

Japan maintains its policy of "Proactive Contribution to Peace" but the report highlights its concern that some nations are unilaterally trying to upset the status quo, and they have accelerated actions to achieve these goals. Germany announced a significant increase in its spending earlier this year to be in line with NATO's 2% of GDP target but has since backed off that goal as the demands on the government are only increasing with food and energy costs on the rise, its economy weakening, and social stresses increasing as evidenced by the recently failed coup attempt. Leaders around the world are being forced to make difficult choices as the demands on governments far exceed the fiscal wherewithal to fund all the needs. Furthermore, the scope of national security has expanded to include those fields previously considered non-military such as economic, technological, and others, and thus the boundary between military and nonmilitary fields is no longer clear-cut.

What is really at stake is a contest of ideologies between democracy and autocracy/dictatorship.

In its recently released National Security Strategy report, the U.S. addressed what it considers the twin challenges facing our nation – out-competing our rivals to shape world order and tackling shared challenges including climate, food and energy security, and the pandemic. The leaders of China and Russia, among others, have very different visions of the future. Each would like to see the United States' role on the global stage diminished, but what is really at stake is a contest of ideologies between democracy and autocracy/dictatorship. China is the one nation with both the desire and capability to challenge the U.S. and reshape the international order in a way that favors China and hurts the United States and its allies.

Re-industrialization of the Global Economy

A core element of the shift is the need to secure, stable, and trusted supply chains. We cannot stress enough the importance of this shift and its longer-term implications.

The manufacturing sector of the United States has struggled for decades to compete with lower-cost labor around the world. Companies were under enormous pressure to outsource production to low-cost countries or risk losing competitiveness. That process is reversing as the world's problems converge with the considerable competitive advantages that the U.S. enjoys, particularly its supply of energy resources, rule of law, and a culture of innovation. Beginning with the previous administration's focus on China's anticompetitive practices and intellectual property theft which was followed by supply chain disruptions due to the pandemic and the war in Ukraine, the United States now stands to become a premier global manufacturing region. In support of this, the U.S. government is beginning to provide incentives, such as tax breaks, to encourage businesses to locate factories in the U.S. and to invest in research development. As shown in Chart 2, there were nearly 350,000 manufacturing jobs that came to the U.S. last year versus only 6,000 jobs in 2010. The rise in the number of jobs created by the return of manufacturing from China and elsewhere to the U.S. is the result of companies bringing jobs back and foreign companies seeking a more stable production environment. Europe is losing some of its competitive advantage due to the war and rising energy prices. A core element of the shift is the need to secure stable and trusted supply chains. We cannot stress enough the importance of this shift and its longer-term implications.

Chart 2. Jobs Returning to U.S. from the Rest of the World

Source: Reshoring Initiative

As shown in Chart 2., there were nearly 350,000 manufacturing jobs that came to the U.S. last year versus only 6,000 jobs in 2010.

With all these jobs coming to the U.S., unemployment down to 3.5%, and over 10.5 million job openings in the United States, Congress needs to address our flawed immigration system and adapt a policy that will address the current and future labor shortages and skills gaps. Like most leading economies, the U.S. has a rapidly aging workforce with declining birth rates making a proper immigration policy an even bigger priority. Given current conditions, securing our border and developing a policy targeted at filling critical shortages across industries would be in the best interest of the country and must be a top priority for Congress.

Congress needs to address our flawed immigration system and adapt a policy that will address the current and future labor shortages and skills gaps. The U.S. has a rapidly aging workforce with declining birth rates making immigration policy an even bigger priority.

Investment Opportunities in Three Acts

For many years we have deplored the deterioration of our infrastructure but finally legislation has been passed to spend $1.2 trillion to rebuild roads, bridges, create high-speed internet access for those who don't have it, improve our ports, airports, clean water, electric vehicle chargers, upgrade and strengthen our electrical grid, as well as a focus on climate change mitigation. Because the transportation sector is the largest single source of greenhouse gas emissions, $39 billion of new investment is committed to modernize public transit as well as $90 billion in guaranteed funding for public transit over the next 5 years. Including additional targeted areas for this legislation, it is estimated that the U.S. could add 1.5 million jobs per year for the next 10 years. Just with respect to railroads, $66 billion is allocated for additional rail funding to modernize the Northeast corridor and bring first rate service to areas outside the northeast and mid-Atlantic. Further, the global shifts described in this Outlook spell increasing demand for the components and materials required for wind power, solar power, conversion of the vehicle fleet to electric propulsion, and the expansion of the electrical grid. In short, the resulting productivity improvement will be a powerful antidote to inflation over time as the benefits to higher living standards become clear.

The resulting productivity improvement will be a powerful antidote to inflation, over time, as the benefits to higher living standards become clear.

Two more pieces of legislation, the CHIPS and Science Act of 2022 ("Act"), and the $858 billion Defense Authorization Bill, will also result in a significant expansion of the U.S industrial base. In 1990, the U.S. manufactured 37% of the world's semiconductor chips and today we produce only 10%, but that is about to change. With the introduction of the $280 billion CHIPS and Science Act in August of last year, Congress took an important step toward ensuring that the United States will remain a leader in the production of advanced technologies. The national security aspect of the Act recognizes that Taiwan-based companies account for about 73% of global market share for semiconductor production today. Therefore, it is vital for the U.S. to dramatically reduce its dependence on Taiwan which is being targeted by China. The CHIPS Act includes an estimated $39 billion worth of investment tax credits over the decade. The Act also calls for $13.2 billion in workforce development which is particularly significant as the Department of Commerce estimates that an additional 90,000 workers will be needed by 2025. There is $2 billion allocated to focus solely on legacy chip production for the auto industry, national defense, and other critical infrastructure, including charging stations. It is worth noting that companies receiving federal incentive funds under the Act are prohibited from expanding or building manufacturing capacity for advanced semiconductors in countries considered to be a national security threat.

The private sector has announced dozens of projects to increase manufacturing capacity in the U.S. including over 40 new projects involving the construction of new facilities and the enhancement of existing sites as well as the facilities that supply the industry.

Since the introduction of the Act, the private sector has announced dozens of projects to increase manufacturing capacity in the U.S. including over 40 new projects involving the construction of new facilities and enhancement of existing sites as well as the facilities that supply the industry, nearly $200 billion of private investments announced across 16 states to increase domestic manufacturing capabilities, and 40,000 new high-quality jobs have been announced for the industry. Both domestic and foreign companies such as Global Foundries, Intel, Samsung, TSMC, Texas Instruments, and Micron are planning to build or have under construction at least 9 new fabrication facilities. It takes about 3 years and some 6,000 workers to build one facility at a cost of at least $10 billion. Taiwan-based TSMC alone plans to spend $40 billion in the U.S. Estimates of expenditures total several hundred billion dollars. Manufacturing equipment can cost as much as $250 million per machine and each plant can require at least 35,000 tons of steel to construct. When taken all together, the numbers are considerably larger than the total manufacturing investment announced by the Administration. Bear in mind that manufacturing jobs have a high multiplier effect adding an estimated 3-4 jobs to the economy for each manufacturing job created, making a tight market for skilled labor even tighter.

These conditions should also push companies to incorporate more robotics and automation into the U.S. manufacturing system.

These conditions should also push companies to incorporate more robotics and automation into the U.S. manufacturing system. The Act is designed to allow the U.S. to control access to advanced technologies for economic competitiveness and national security reasons.

The war in Ukraine has forced global leaders to refocus on the importance of strong military capabilities as a form of deterrence. The heroic and innovative defense by the Ukrainians is also redefining the future of war as we have seen drones, cyberattacks, and other non-traditional forms of warfare used effectively against what should be a superior military. In response, NATO nations are stepping up their spending, and the United States is as well. The Defense Authorization Act calls for a 4.6% pay increase for both troops and the civil employees of the U.S. Department of Defense. In its new National Security Strategy, the U.S. identifies China as the biggest concern with Russia and other terrorist state actors also a key part of the strategy.

Chart 3. The Defense Authorization Bill

FY23 Defense Funding Levels (in billions of dollars)	
Department of Defense	$ 817.15
Department of Energy	$ 29.71
NDAA Topline	$ 846.86
Defense-related Activities Outside NDAA Jurisdiction	$ 10.6
National Defense Topline	**$ 857.46**

Source: U.S. Department of Defense

The bill also advances air power, land warfare capabilities, advanced munitions, sea power, undersea warfare, aircraft procurement, and weapons procurement with production increases.

The Defense Bill will increase the munitions stocks if China were to act against Taiwan. This will involve the largest number of multi-year procurement contracts that has been authorized in recent history. To make sure the industrial base and those allied nations can meet the demand required for Ukraine, bureaucratic red tape will need to be reduced. While the Act runs 4,400 pages, we note that 11 battle force ships are authorized for procurement and the early retirement of 12 ships has been reversed. The Navy's budget had been to build 8 ships and decommission 24. The bill also advances air power, land warfare capabilities, advanced munitions, sea power, undersea warfare, aircraft procurement, and weapons procurement with production increases. In addition, $1 billion is allocated for the National Defense Stockpile to acquire strategic and critical industrial materials.

January 12, 2023

After a difficult year in the markets, it is easy to dismiss the public markets as an attractive area to find opportunities in 2023, and that would be a big mistake.

After a difficult year in the markets, it is easy to dismiss the public markets as an attractive area to find opportunities in 2023, and that would be a big mistake. Unlike the past decade, financial market returns could struggle with weak economic growth with the key difference this time being materially higher interest rates, a higher cost of living, and much more limited bandwidth for governments to provide fiscal and monetary support. While there are major differences between then and now, the bursting of the tech bubble in 2001 led to a major shift in market leadership, and ARS was able to identify areas to protect and build capital in the subsequent years by investing in previously underfollowed and underappreciated parts of the economy. Today, we recognize that there are defense, steel, industrial companies, and commodity producers selling at particularly attractive valuations with strong balance sheets and relatively strong growth rates that we believe will be among the market leaders in the coming period. Moreover, many stocks have declined from their highs by anywhere from 20-70% in the past year. While many stocks deserve to be down that much as their businesses never justified their lofty valuations, there are others that are now selling at highly attractive valuations. Lastly, the increase in global interest rates has provided investors with more attractive bond yields, however, equity investors should be better able to offset the inflationary impact on the purchasing power of the dollar over time than fixed income investors. As market participants adjust to the changes highlighted in this Outlook, new leadership is likely to emerge and investors with the vision to look beyond the next quarter or two should be well rewarded.

Wishing our clients and friends a happy, healthy and peaceful New Year.

ARS is pleased to announce that Franco Chomnalez has joined the firm as a Research Analyst. After graduating from Yale University, Franco has worked as an associate consultant and as a senior analyst. Please join us in welcoming Franco to the team.

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