ARS INVESTMENT PARTNERS

THE OUTLOOK

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Investing in an Uncommon Period in History: Are You Positioned for What Lies Ahead?

In This Outlook

The global economy is undergoing tremendous changes requiring investors to step back and take a fresh look at their portfolio positioning. The complexity of the current environment is challenging traditional investment thinking regarding the impact of monetary and fiscal policy on inflation, interest rates, and corporate profits, especially given the potential for change stemming from the introduction of generative AI and the ongoing issues with the climate transition. This piece explores the divergence between the market's expectations for rate cuts and what the Federal Reserve is most likely to do, a key differentiator between the market and ARS. Our consistent stance has been that rates would remain elevated for a longer duration than the market expected, a view that has gained greater acceptance in recent days. The United States economy and businesses remain standout opportunities, and we expect capital flows to continue to favor the U.S. and its leading companies. Today, investor portfolios should emphasize sectors such as industrials, materials, healthcare, energy, and technology, and active versus passive management. Given the differences of this period versus previous ones, we believe that investors need to rethink their portfolio positioning.

"Think about the race of artificial intelligence ... think about the geopolitical tension and the threat of fragmentation we will have to deal with over the next years. The higher debt levels after the pandemic and the energy price hikes, which has shrunk our fiscal space to finance transformation, and given ... little growth perspective of the global economy. Has 2023 given me hope? ... I would put it this way: It was a call for action because we have to rearrange some policies and ... probably we are at the beginning of an era of new structural reforms."

– German Finance Minister Christian Lindner, January 19, 2024

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We are living at a point in history unlike any other. The aftermath of the events of the past 15 years has exposed cracks in the foundation of the world order, the global economy, and the markets. However, the negative sentiment which is so pervasive in society today is also overshadowing investment opportunities that will reshape industries and foster a necessary productivity boom as we enter the age of accelerated computing and generative AI. At the same time, the global economy is transitioning to one which may best be characterized by a return to more historic levels of interest rates while we

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experience major geopolitical, economic, and social transformations. This shift is forcing governments, businesses, and consumers to adjust to the highest interest rates seen since 2008. Yet unexpected to many, the global economy has proven more resilient than many economists had anticipated as growth has surprised to the upside, inflation has moderated, and employment has remained strong. With concerns regarding the upcoming U.S. election, the further escalation of conflicts, elevated levels of debt, worsening demographics and immigration issues, this is certainly plenty for investors to contemplate.

Throughout our 53-year history, ARS has often seen the world through a different lens than other investors which has led to portfolios with differentiated holdings and sector weightings versus the typical institutional portfolio. We believe that today, many investors could be asking the wrong questions regarding the economy and the markets as they are hoping for further support from central bank policy to boost returns by cutting interest rates. Many investors rely on thought processes and computer models that are grounded in past cycles. However, this approach has led to inaccurate conclusions, as they do not account for the significant differences in the current environment compared to those in the past. The next few years will continue to be unlike any previously experienced since these transformations have important implications for public and private capital expenditures, consumption, and investments. Market participants should ask themselves: Is my portfolio invested based on market hopes and anticipations or is it aligned with what is more likely to happen?

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Are We Asking the Right Questions?

"We have a strong economy. Growth is going on at a solid pace. The labor market is strong: 3.7% unemployment. With the economy strong like that, we feel like we can approach the question of when to begin to reduce interest rates carefully."

– Jerome Powell, Chair of the Federal Reserve, February 4, 2024

For some time now, most market participants have been asking "how soon and by how much is the Fed going to cut rates?" but the better question is "why should the Fed cut rates now?" The Federal Reserve's mandate is to achieve maximum employment and price stability while maintaining economic growth. Based on those measures the U.S. economy is in surprisingly good shape. The just-released Consumer Price Index (CPI) and Producer Price Index (PPI) reports indicated that the inflation fight is not yet won as the January numbers came in above market expectations. Chair Powell's remarks reiterated the views expressed in our January Outlook as we felt the market's expectations for rate cuts were not consistent with our read of the economy and the Fed. The challenge for the Federal Reserve is that they do

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not know where interest rate policy should be set so as not to be too restrictive or too expansionary, in order to achieve its goals. Since the December meeting, market participants have dialed back expectations for the amount of interest rate cuts from 1.75% to around 1.00% for the year. Clearly, the market got ahead of itself as the Fed member's December Summary of Economic Projections only called for 0.75% reduction, or three 0.25% cuts.

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The Fed does not embark on a policy change of lowering interest rates without a valid reason, and while reasonable people can disagree, Chair Powell believes that the timing is not yet right to begin reducing rates and ARS agrees. Both monetary and fiscal policy work with long lags, meaning its impact may not be felt for 12–24 months, and the market has underappreciated the continued strength of the economy given the massive scale and duration of approved fiscal spending programs. That does not mean that the Fed might not need to lower rates at some point, but there are three key factors that market participants may not be weighing enough. First, the markets may be missing the scale and the impact of the monetary and fiscal support provided to the U.S. system since the pandemic. This includes the several trillion dollars of support from the Infrastructure Investment and Jobs Act, Inflation Reduction Act, the Chips and Science Act, and the National Defense Authorization Act which will see funding of projects continuing for several more years with additional spending from the private sector and state and local governments. Second, the markets held the belief that monetary policy tightening, such as what we have experienced during the past 24, months always causes a recession. It also typically causes a financial crisis like the one narrowly avoided last year with Silicon Valley Bank. The post-pandemic period has seen industry after industry experience some slowing and, for many, a recession. It is just that the impact has not all hit at the same time allowing the economy to continue to grow above expectations. Finally, the U.S. consumer today is vastly different from past periods as more baby boomers are moving into retirement with $75 trillion in net worth and time on their hands to spend it. While many families are struggling with paying bills and have seen their excess savings drawn down considerably, the boomers can continue to be significant spenders and help to offset some of the slower spending of others. Moreover, the federal government will continue to spend, offsetting any potential weakness in consumer spending.

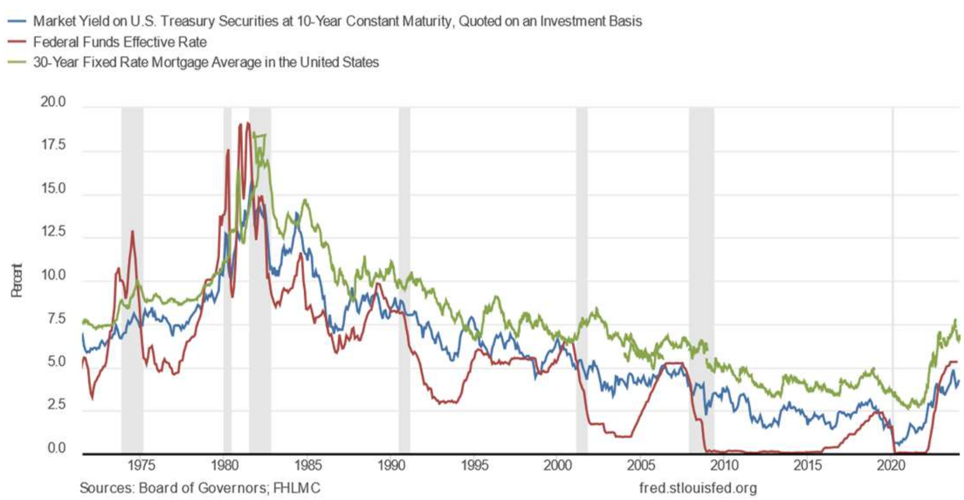
The problems of China and Germany, two of the world's biggest manufacturers, have helped strengthen the U.S. dollar which means that U.S. imports cost fewer dollars, in effect lowering prices, thereby helping to do some of the Fed's work.

Why Does This Matter for Investors?

2024 ARS focuses its research efforts on defining the global environment and identifying undervalued businesses that stand to benefit. Why so much focus on monetary and fiscal policy and, in particular, the outlook for inflation, interest rates, and corporate profits? It is because the basis for securities valuation is dependent on these three inputs. The following are our current views on each.

Inflation — There are many reasons the Fed may not be motivated to cut rates as it has made excellent progress on bringing inflation down towards its 2% target while maintaining solid growth and full employment. If the Fed is too aggressive on rate cuts, it could further stoke inflationary pressures by stimulating more spending. Additionally, the problems of China and Germany, two of the world's biggest manufacturers, have helped strengthen the U.S. dollar which means that U.S. imports cost fewer dollars, in effect lowering prices, thereby helping to do some of the Fed's work. Finally, labor shortages and increasing wages for 2024 will put upward pressure on costs and inflation, reinforcing the Fed's patient stance on lowering rates.

Chart 1. U.S. Fed Funds, 10-year Treasury and 30-year Fixed Mortgage Rates 1971 to Today



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Interest rates — What would cutting interest rates do at this time? In the near term, it would be good for short-term growth, for the markets by expanding price/earnings multiples, for new homebuyers as well as highly indebted companies and governments. However, it would also likely reignite inflationary pressures which the Fed is determined to avoid. Chart 1 illustrates the levels for the Federal Funds Effective Rate, the market yield on 10-year treasuries, and the 30-year Fixed Rate Mortgage average since 1971. While current rate levels are high compared to the experience of the past 15 years, they are not high on a historical basis. Given current conditions, it is not likely that we will see rates trend much higher, but also not much lower barring a major event or a significant policy misstep.

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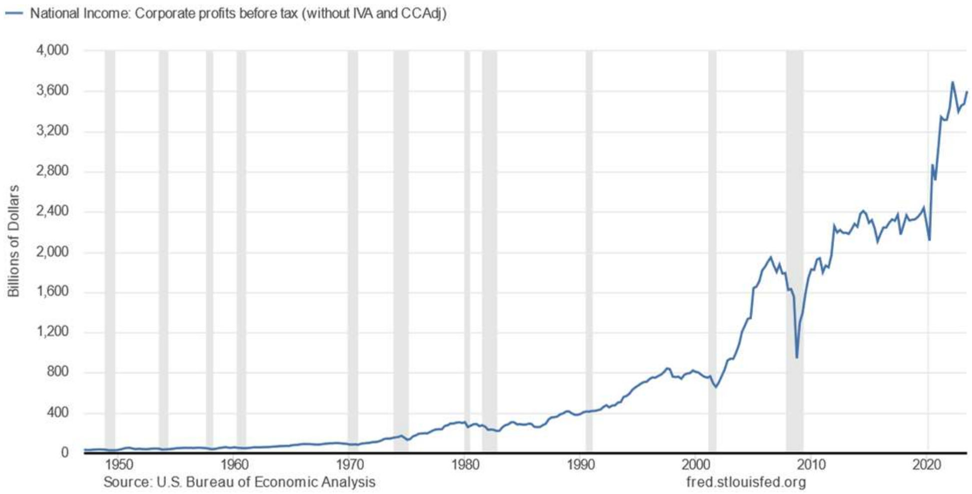
Chart 2. U.S. Corporate Profits Before Tax



What is particularly impressive is the tremendous profit growth in recent years given the challenges of the post-Great Financial Crisis (GFC) period as pre-tax profits jumped from $1.9 trillion in 2006 to $3.6 trillion last year.

Corporate profits — A question for investors to consider this year is "can markets produce another year of positive returns given the economic headwinds?" Chart 2 illustrates U.S. pre-tax profits growth from the 1940s to today. What is particularly impressive is the tremendous profit growth in recent years given the challenges of the post-Great Financial Crisis (GFC) period as pre-tax profits jumped from $1.9 trillion in 2006 to $3.6 trillion last year. That jump does not yet take into account the additional profitability that companies will realize with the productivity increases coming from generative AI and other technological advances. After an almost 15-year period of massive monetary and fiscal policy stimulus providing tailwinds for corporate profits, the tighter money conditions that exist today will favor those companies with strong balance sheets, competitive moats, and relatively inelastic demand for their products. Many large corporations have announced layoffs and other efficiency initiatives designed to manage profitability in what many CEOs are projecting to be a challenging environment. Notwithstanding this, we are excited about the opportunities to invest in select sectors, industries, and companies. Coming into the new year, ARS felt investors would experience positive returns from many U.S. equities, and nothing has transpired to date to change that view.

Are You Positioned for What Lies Ahead?

"One of the most striking aspects of the generative AI revolution is that it is just getting started. Its main drivers — computing power, data, talent, and funding — are compounding at a scale and speed that will accentuate its disruptive forces. No wonder it has risen to the top of the agenda for chief executives in an ever-increasing number of companies and industries."

– Mohammod El-Erian, President of Queens College, Cambridge, and advisor to Allianz and Gramercy. *Financial Times*, February 15, 2024.

It is in times like these that businesses innovate and adapt to create new opportunities for investors to build and protect capital.

What the markets will do in the near term is anybody's guess, but it is in times like these that businesses innovate and adapt to create new opportunities for investors to build and protect capital. Many investors have no problem investing when the markets have a clear direction as they tend to just follow the crowd. However, this is not one of those times since current market dynamics favor individual stock selection over index investing, and the United States market over most global markets.

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Moving forward, ARS expects a prolonged global low-growth environment with big opportunities for a limited number of countries and companies. The countries that will benefit will be those with relatively favorable demographics, fiscal policies to support the ongoing transitions, access to capital, dependable sources of energy, national corporate champions driving the technological revolution, and low dependence on adversary nations for key resources. ARS sees the world through a different lens than most investment firms, and that results in highly differentiated portfolios as reflected by our overweights in the energy sector; industrials sector including defense and reindustrialization beneficiaries; materials sector which is critical to technological leadership, the energy transition, and national security; healthcare sector which stands out as a leading beneficiary of generative AI, and the technology sector with a focus on cloud, data infrastructure, semiconductor chips, and capital equipment providers.

A fundamental theme is the growing demand for and use of advanced technology to increase productivity, lower costs and raise living standards.

We favor companies that are among the leading beneficiaries of the reindustrialization of the U.S. economy, those that are driving productivity increases to offset rising labor costs, enhancing healthcare outcomes, and those that are critical to national security. A fundamental theme is the growing demand for and use of advanced technology to increase productivity, lower costs and raise living standards. Additionally, the businesses that will reward investors in 2024 will be those with relative inelasticity of demand for their products. We expect corporate earnings to continue to increase, but the benefits will not necessarily flow to all companies equally. Investors should anticipate periods of volatility, but since we anticipate rising corporate earnings, it should not be a surprise to see the markets continue to make new highs in 2024.

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