Investing 2022: A Polar Bear in a Snowstorm

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Financial markets remained turbulent through the second quarter of 2022 as inflationary pressures, interest-rate hikes, and the ongoing war in Ukraine weighed on investor sentiment, and we've come to accept that the future will likely look different from the past. But we believe this shifting environment could create investment opportunities—for those who can find them. Like a polar bear in a snowstorm, they will likely be hidden, but we believe our active approach will help us identify them.

Higher Inflation, Lower Growth

As we discussed last quarter, the previous two years have been unique in many ways. Most recently, our assessment of a post-pandemic world has changed based on the implications of Russia's invasion of Ukraine, which led to the risk of higher prices and lower growth increasing from our original forecasts.

We now expect U.S. inflation to peak later than we originally expected and to roll over much more gradually than previously expected. Within Europe, we expect the peak to come later than it does in the United States as energy and commodity prices continue to drive inflation. We also continue to monitor wage growth, which is still a key variable but remains negative in real terms and has not added to inflationary pressure at this point.

We expect growth to continue to slow, settling to levels below our earlier projections. European growth is most at risk, and will likely be materially lower, as the impacts of the war limit the European economy's ability to reach its pre-COVID gross domestic product (GDP) trajectories this year. In the United States we expect growth to end the year up 2% to 3%, but sequential growth will also fall to near zero. While the probability of a recession will increase, we believe a deep or prolonged recession remains unlikely.

Decelerating Earnings Growth

Corporate earnings growth, especially outside the United States, is widely expected to decelerate through much of 2022, yet we have seen very few negative revisions. Given the persistent inflation and macroeconomic uncertainty, we expect that to change with second-quarter corporate reports and the related outlook commentary for the balance of the year. While some of that expected deceleration has been reflected in multiple contraction, negative earnings revisions may continue to put further downward pressure on multiples.

Region-Specific Outlook

The rising-rate and strong-dollar backdrop can be problematic for emerging markets, but every cycle is unique, and our outlook remains region and country specific.

The major Latin America and Middle East countries are actually well positioned for this environment, in our view.

In Asia, India may be more vulnerable given its commodity dependence and generally high market valuation.

The mixed outlook for China is interesting to us. The low vaccination rate among the older population creates a potential for a resurgence in the pandemic, and its effect on growth remains at the forefront. The regulatory overhang and heightened geopolitical risks continue to weigh on sentiment, though the recent regulatory cycle has peaked.

Conversely, we have begun to see some easing of the COVID lockdowns that will likely lead to accelerating demand. In addition, we think the Chinese government’s focus on stable economic growth will lead to moderate fiscal stimulus and potential for monetary easing, in stark contrast to many other major countries.

Broadening Our Growth and Valuation Profiles

While our base case is that we avoid a deep recession and inflation ultimately proves manageable, we are broadening the growth and valuation profiles of our strategies to create more balance in this time of economic uncertainty.

For at least the balance of this year, we will focus our research on companies that can manage input costs and have pricing power, protecting their growth and margins. Higher-quality companies should be able to demonstrate their leadership, and with the valuation contraction of quality, we think this will be fruitful for us. Markets are likely to focus on visibility of growth, relative changes to growth rates, and lower-duration equities.

Longer term, we believe the outlook for equity investing may be shifting as well, with increased risk that the growth, inflation, and interest-rate environment may be more different from what we have experienced in the recent past. Thus, against this backdrop, equities may continue to be under some pressure.

While that may seem to present a headwind, we focus on what hasn’t changed and our unique approach as equity investors. As discussed previously, the innovation and disruption cycle hasn’t changed, and arguably, it has even accelerated. We have continued to see a dynamic shifting of corporate winners and losers. And we believe the durability of improvements in corporate competitive advantage remain underappreciated. These aspects are very much the focus of active growth investors like us as we try to predict the future.

The precise value of those advantages will need to be recalibrated slightly, but understanding companies that have truly differentiated, durable competitive advantages that are likely to persist into the future will remain, in our opinion, the core of great growth investing.

Relating to growth, we continue to see the ongoing shift toward digitalization. We expect this shift across myriad industries, ultimately accelerating on the industrial side of the economy. What 4G did for the consumer side of the economy, 5G could do for industrials, healthcare, and other sectors.

In addition, the last decade has seen a unique concentration of winners, both within entire industries and individual companies. We think this may be at risk of shifting back to something more balanced, similar to what we saw in decades prior.

We are also interested in industries that fit into the notion of a shifting opportunity set, including those that haven't experienced much growth recently but could benefit from the environment we're likely to be in. Examples may include banks and natural resource companies in different parts of the world.

It will be exciting, over the next several years, to seek the so-called polar bear in a snowstorm—uncovering those underappreciated growth opportunities—and doing so in an environment in which we might see more diversity of growth.

And we have the advantage of breadth. Our investment universe has always been inclusive of high-quality, high-return companies with varying growth rates across many industries and countries.

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