Tectonic Shifts in the Investing Landscape

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Much like the heat from radioactive processes inside the Earth causes tectonic plates to move—sometimes in one direction and sometimes in another—the dynamic shifting of corporate winners and losers remains a constant.

Reflecting on Unique Times

As we begin the second quarter of 2022, we reflect on the unique environment we have experienced the last two years.

The nature of the economic cycle, originally due to the COVID pandemic, has been amplified. We've experienced an extreme closing and reopening of the global economy accompanied by unprecedented liquidity and pronounced rotations in style—first with growth outperforming strongly, and more recently value charging back.

Lastly, the Russian invasion of Ukraine continues to impact the economy and the markets, and in response we have reassessed our outlook leading into this year.

What is that outlook? Similar to our forecast earlier this year, we see a natural slowing of economic growth from the very high levels seen in 2020. We anticipate rising inflation, which implies a further deceleration of earnings growth. We also continue to analyze the rising-interest- rate environment and its relationship to valuations. We will discuss these topics in great detail in our upcoming global disruption series, but for now, let's look at each area in brief.

Growth: Post-Russian Invasion

In terms of growth, we continue to see risks of slower economic and corporate profit growth than we had originally expected.

In contrast to our prior outlook, we now expect materially lower growth in Europe. Leading into the year, most European economies remained much below their pre-pandemic output trajectory; now the Russian invasion of Ukraine has created further downward pressure. Particularly in Eastern and Central Europe—expanding past Russia into Hungary and Poland—we expect continued inflation acceleration, currency pressure, and higher interest rates.

In the United States, we see less of an impact from the Russia-Ukraine conflict, and therefore expect growth to remain at broadly similar levels to our pre-invasion base case: a significant sequential deceleration in economic activity from approximately 5.5% growth (which we observed in 2021) to closer to 2.5% by the end of 2022. Corporate profit growth expectations seem reasonable and remain high for most major countries.

In China, our outlook is mixed. We've seen a resurgence of COVID cases and lockdowns (which we expect to impact economic activity and weaken growth in the first half of 2022) coupled with potential geopolitical risk. But we believe the government's focus on a stable economic environment will lead to a moderate fiscal and monetary stimulus as well as potential for some easing of regulatory pressures. Valuations in China are also relatively attractive, in our view, after a difficult 2021.

Inflation

The ongoing lockdowns and the military conflict in Europe have prompted us to revise our inflation projections further. We originally expected inflation to peak early this summer; we now believe that it will peak at a higher rate in the later part of the year and roll over thereafter.

Of course, we were always going to monitor wage pressures because they remain a key variable in the United States and have the potential to impact global equity markets. Corporate earnings growth, especially outside the United States, is expected to decelerate further throughout much of 2022, which will put further downward pressure on multiples.

Valuation and Style Performance

Thus far in 2022, we've seen one of the most significant style rotations of the past few decades, and that leads us to a discussion of equity valuations.

The general relationship between rates and valuations holds, and despite the influences of the Russia-Ukraine conflict and persistent inflation, we believe we are in a long-term economic recovery. Thus, we expect gradual monetary tightening and removal of excess liquidity—leading to further multiple contraction as the expansion continues and rates go higher.

This has direct implications for the performance of growth equities relative to value equites, and we have seen this play out significantly since the beginning of 2022. Valuation as a factor has been, by far, the strongest driver of performance year-to-date.

Does this imply that the very long run of quality growth over value is over? We don't think so.

Many of the drivers of growth's outperformance are still in place: positive but lower economic growth, low (albeit rising) interest rates, and a competitive landscape in the real economy. (This competitive landscape acknowledges the structural advantages of some areas of the economy over others as well as the structural advantages of differentiated, innovative business models.)

Moreover, we believe interest rates, as measured by the 10-year U.S. Treasury yield, would need to rise meaningfully from current levels (about 300 basis points) to significantly affect relative future profitability and investment premiums.

The More Things Change…

As the saying goes, the more things change, the more they remain the same. We believe the innovation and disruption cycle remains solid (and, arguably, has even accelerated). The dynamic shifting of corporate winners and losers is a constant, and again, may have accelerated. Importantly, durability (or improvements in corporate competitive advantage) will likely remain underappreciated.

We believe this environment will create an important backdrop for active investing. Understanding companies with differentiated business models, unique cultures, and durable competitive advantages will be increasingly crucial to determining investment performance in this complex environment.

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