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The Mother of All Recoveries

April 27, 2021

The economy and stock market are behaving as we expected thus far in 2021. We've been referring to the post-pandemic economy as the "Mother of All Recoveries," with yearly growth at a level not seen in decades. And we expect this recovery/expansion cycle to ultimately be measured in years, not months or quarters.

Unlike the post-Global Financial Crisis recovery, this cycle will likely be driven by domestic demand, not relying on China's stimulus to drive the global economy.

As we pass the one-year anniversary of the first several weeks of the 2020 global lockdowns, we are seeing evidence of strong business and consumer activity, with purchasing managers indices (PMIs) showing significant growth acceleration in the United States and Europe, and consumer spending accelerating in kind. This continues from the already strong sequential growth demonstrated in the latter part of last year.

This economic activity naturally leads to concerns about inflation and interest rates. We believe that while inflation must increase from depressed levels, it will be driven by healthy growth and will likely remain in a manageable range of +2% to +3%, without much risk of overshooting. Think of this as reflation back to normal long-term historical levels, rather than overheating to levels of concern.

In a related manner, interest rates should continue to creep up as well, but again this is a bounce from unusually low levels, or what can be characterized as a "reasonable" move in rates.

For corporations, the focus will be on earnings growth and leverage to the economic cycle. While consensus earnings estimates have been inching up, we believe analysts largely underappreciate the magnitude of profit growth we will see this year.

We believe cyclical areas of the economy—consumer and industrial alike—will likely have the greatest upside potential to estimates this year. Industrial sectors, like machinery and building products, and consumer services such as travel and leisure are most interesting to us.

It's important to put this into context of what the market expects in the form of valuations. In an economic recovery, the market typically rewards economically sensitive stocks, with little regard to earnings quality or longevity. These stocks are typically cheap relative to the rest of the stock market.

That is precisely what we began to see in the middle of the fourth quarter, after the announcement of vaccine approvals and the result of the U.S. presidential election. The market was collectively relieved enough to start pricing in strong economic growth. This has continued apace in 2021, as mentioned previously.

With higher interest rates, the value of future corporate cash flows is reduced as well, and as expected, we are seeing the valuation multiples of long-duration earners contract. The result is a tempering of the multiple gap between classic growth stocks and value stocks.

Broad-based, abundant growth also reduces the scarcity premium for those special companies who are in greater control of their own destiny regardless of the economic climate. Many observers have commented about the unsustainably wide margin between the two, and it is not surprising now to see a bit of a contraction.

This current relationship between the economy and style performance is consistent with past cycles, and thus we believe it will be a difficult period for our investment style, which targets companies with high and sustainable long-term growth. Most of our investment strategies underperformed their broad core benchmarks during the quarter but fared much better compared to growth indices.

As the economy moves from recovery to expansion, these headwinds should become much more manageable. We look forward to the Mother of All Recoveries quickly giving way to what might be the Mother of All Expansions.

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