Strategist's Corner
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Where to Focus As the Bill Comes Due

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There are few immutable economic laws, but to my mind there's at least one: Nothing is free. Everything has a price, even though the cost might not be clear at the time of purchase.

Such was the case during the early days of the pandemic two years ago, when policymakers in developed markets used every tool at their disposal and often created new ones to counteract the negative economic consequences of temporarily shutting down the global economy in the name of public health. Now the bill for that has come due, and policymakers are suffering from sticker shock. But should they be surprised that inflation has zoomed to a four-decade high?

To be sure, some of the inflationary fallout is not their fault. Supply chain snafus, rising labor costs (1,000 years of history shows that labor force participation slumps following every pandemic) and Russia's invasion of Ukraine are factors beyond the control of central bankers, legislators and national leaders.

But in my view, much of the inflation we're experiencing is the price we pay — after an 11-year post–global financial crisis period of growing imbalances — for making one of the steepest recessions in history vanish in a matter of weeks by flooding the system with previously unimagined levels of monetary and fiscal stimulus. It's as though policymakers didn't just buy everyone in the bar a drink; they left the tab open all night.

So now the bill has come due and everyone from households and companies to politicians and central bankers is trying to figure out how to manage through the resulting inflation.

But before we get hysterical, let's remember that historically, the cure for high commodity prices has been high commodity prices, as a portion of demand will no doubt be destroyed, for example, by driving less or turning down the thermostat to save fuel. Inflation will also cause households and businesses to restrain their discretionary spending, which should lead to slower (or falling) growth, the opposite of what happened in 2020 and 2021, when economic growth was rising and inflation was falling. Across global developed markets, that 18-month, stimulus-fueled period produced double-digit economic growth and a 25% revenue expansion along with declining costs, leading to a doubling of profit growth. That helps explain why equity returns were in the top 1%. But was it free? No.

The price we're paying is normalizing (or falling) growth and higher prices. Revenue growth was falling and costs were rising well before 2022 began, and we think that trend will intensify in the quarters ahead.

Investors need to ask themselves, amid rising interest rates, lower returns and higher uncertainty around cash flows and profit margins, what valuation will they be willing to pay when they are offered, as they soon will be, returns in the range of 1% to 2% on cash?

You don't need a degree in finance to see the probable future direction of travel. Lower-margin and lower-quality assets should decrease in value and create scarcity value for high-quality companies with the ability to protect margins. It's an environment that should, in my view, favor active management over the long term.

A look through a different lens

Over the past 500 years, financial market manias have come like the tides: The incoming tide wipes out everyone who bets against it. Later, however, the outgoing one wipes out those who bet with it. The late-1990s and the US housing bubble of the mid-2000s are prime examples of this pattern.

Most recently, anyone who was underweight low-quality cyclicals (major beneficiaries of the stimulus described above) and high P-E "concept" assets, such as biotech or cloud companies, significantly underperformed passive strategies. But in my view, we're closing in on high tide and investors who bet on it rising further will get their comeuppance while those quality companies who compound above-average margins on a secular basis will assert market leadership.

When uncertainty is high like it is today, investors may want to concentrate on owning assets where cash flow visibility is clearer and where the products are mission-critical and underowning assets where profits are dependent on factors outside of companies' control or on unproven concepts.

Price/earnings ratio (P/E) is the price of a stock divided by its earnings per share.

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