

Regime Change – Higher for Longer and the Case for Profitable Companies

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From the Desk of Dan Veru, Chief Investment Officer

When the Federal Reserve Chair shares his game plan and then follows through, we believe it makes sense to take him at his word that the Fed's policy-making Open Market Committee will stay the course in its battle against inflation. This strategy has been clear to us since the beginning of 2023, but for some reason, many investors have continued to believe that Chair Jerome Powell and his Fed governors would cut interest rates at the first sign their tighter monetary policy began to have its intended effect of reducing inflation by slowing the economy. The market is finally waking up to the reality that there is a lag effect of these policies, but something else is happening. A regime change has occurred where interest rates may remain higher for longer due to structural changes to the U.S. and global economies, making the Fed's stated target of 2% for inflation difficult and somewhat aspirational.

The Federal Reserve has raised the Fed Funds rate from zero in March of 2022 to a range of 5.25%-5.50%, the fastest and most dramatic increase in rates ever, but the economy, while slowing, has shown an ability to be very resilient. Inflation has come down from peak levels of last spring and the Fed chose to hold rates at current levels at their last two meetings. This may indicate this tightening cycle is over but does not necessarily mean longer dated Treasury yields (5-year to 30-year) will stabilize (or rise). We have seen yields on longer maturing government bonds, especially the closely watched 10-year Treasury, increase since the beginning of 2023 and this could help the Fed's efforts to slow the economy while continuing to reduce the rate of inflation.

The reason longer maturing treasury bond yields are rising is multi-faceted, but a concerning factor could be the size of the federal deficit which has expanded while interest rates increase. The cost of funding this ballooning debt is heading skyward. The U.S. Treasury's net interest expense as a percentage of tax revenues hit 14% this past July, as calculated by Strategas Research Partners. Historically, interest expense representing 14% of tax revenue has emboldened "bond vigilantes" refusing to buy bonds without higher interest rates. If the past is any indication of the future, this dynamic has served as a catalyst to reign in profligate spending (which has been an economic tailwind while interest rates were low). Since May, the yield on the 10-year Treasury note has soared over 120 basis points as of October 31, 2023, and the "vigilantes" may very well continue pushing yields higher independent of any action by the Federal Reserve.

No matter how they are applied, these economic brakes should slow the pace of inflation closer to the Fed's target, but we believe that will take time. While goods inflation has declined thanks

to the rise in interest rates and the repair of global supply chain disruptions, a still-strong labor market means the goal of lowering wage inflation will be a far greater challenge. Services, and indeed all sectors where labor drives input costs, remain subject to substantial price increases. A settlement of the autoworkers strike, for example, will drive up the cost of manufacturing vehicles, much of which, we can expect, will translate to higher sticker prices.

Reshoring—companies moving sourcing back to the United States—will be inflationary as well. Rather than “just-in-time” sourcing, which showed its shortcomings during the pandemic, executives are embracing a “just in case” approach to sourcing their companies’ essential supply chain needs. Given the availability of energy, especially natural gas, the U.S. is again a preferred place to set up additional manufacturing for critical components like semiconductors, solar panels, and other high value components. This revival of U.S. manufacturing could be particularly healthy for small cap companies presented with new business opportunities, but it will put upward pressure on prices for years to come. “Just in case”, while necessary, costs substantially more than “just in time”.

As investors, how do we respond to such a fiscal and monetary backdrop? We believe equity investors should limit exposure to duration, or the sensitivity of a stock to rising interest rates, by identifying companies that have profits today, and not in the future. We believe conservatively capitalized companies with strong free-cash-flow have the potential to outperform if interest rates stay high or go even higher because these companies have options other less profitable or levered companies do not. “Short duration” companies that generate lots of cash are less susceptible to the rise in the cost of capital since they produce more cash than needed to run their businesses. Moreover, because of their ability to generate cash, we believe the stocks of these companies should become more desirable to investors in a rising rate environment.

Under a higher interest rate regime, the present value of a future stream of earnings is worth significantly less than it was just two years ago, so our view is that companies with rich valuations because of their potential for big earnings down the road are likely to face valuation challenges in the stock market. This explains why promising companies in biotech are getting hammered; the S&P Biotech ETF is down 20% year-to-date as of October 31, 2023. The higher cost of capital will also become a burden to heavily leveraged companies that will need to issue bonds at today’s higher rates as they retire their low-interest debt.

With strong free cash flow, a company is well positioned to make acquisitions, buy back stock, or pay dividends, even in a high-interest-rate environment. We prefer the first two strategies. Strategic acquisitions can leverage a company’s earnings power, while stock buybacks increase return on equity and boost earnings. These are the types of stocks that we are purchasing for clients today, holdings we believe could outperform the market in the new regime of higher interest rates and a slowing economy.

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