Strategist's Corner
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It's the Second Mouse That Gets the Cheese

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In brief

- The markets are awash in crosscurrents, so it's critical to focus on what's material and filter out market noise.
- Profits are a function of revenues versus costs, and we think that revenue growth is vulnerable and costs are likely to rise.
- We expect high-priced financial assets that deliver underwhelming fundamental performance to be repriced while stocks and bonds of companies that meet expectations may be in short supply, earning them a scarcity premium.

There are always crosscurrents in financial markets, but today they seem particularly strong. A few cases in point: We're seeing massive strength in corporate profits while economic growth decelerates. Demand for both goods and labor is outstripping supply, yet developed market sovereign bond yields imply a very tepid economic backdrop. And investor demand for risky assets is at multidecade highs, yet the cost of insurance is unusually elevated as a fair number of investors hedge their portfolios.

When things get complicated, I find it helpful to try to simplify them. In its simplest form, investing is an exchange of capital for a stream of future cash flows. The cost of capital is set by its providers based on the riskiness of the investment and the probability of realizing promised cash flows. What makes investing difficult, of course, is that the future is unknowable. Investors can only theorize about a project's potential for success or failure in terms of a range of potential outcomes.

Is investing more difficult today?

Technology has democratized information, and society is more informed than ever before. We have infinite and instantaneous access to news. However, I question whether that has improved investors' ability to price risk. As John Naisbitt writes in Megatrends, "We are drowning in information but starved for knowledge."

While an economic or political headline may be newsworthy and important, it's often irrelevant to the long-term health of a particular company and its cash flow stream. For instance, are the effects of a central bank reducing its current pace of asset purchases really material to the five- or 10-year profit outlook of a global hotel operator? Or will the prolonged suppression of a country's risk-free rate save an uncompetitive brick and mortar retailer from the growing threat of e-commerce?

Deciding what matters and what doesn't has gotten a lot harder. In my view, successful long-term investors have the ability to distinguish meaningful information from market noise. To be clear, reaction time to a data point is not a differentiator. The differentiator is the ability to disregard what isn't material and incorporate what is. If after careful consideration new information is seen as altering the most probable profit path, then action is warranted.

Where are we now?

Given the number crosscurrents and the level of noise today, a simple review of how we got here might clarify the picture.

- In response to the 2020 cash crisis caused by the lockdown, companies eliminated nonessential costs.
- When credit markets thawed after extraordinary central bank interventions, corporate leverage and balance sheets exploded.
- Well into 2021, the combination of direct payments to consumers, pent-up demand, vaccines and economic reopenings catalyzed a step-function increase in worldwide corporate revenues.
- The convergence of depressed corporate expenses, higher financial leverage and massive revenue gains resulted in a near-doubling of global corporate profits. Margins are back to their pre-COVID heights, and profits have soared well beyond late-2019 peaks.
- Financial markets began to discount the profit explosion in mid-2020, and risk premia, investment return an asset is expected to yield in excess of the risk-free rate of return, steadily declined to the historic lows we see today. Consequently, all that good news is in the price, which, in my view, means that the risks substantially outweigh the near-term rewards.

What's ahead?

Profits are a function of revenues versus costs, and in our view, revenue growth is vulnerable while costs are likely to rise.

We think revenue growth rates will decelerate as the current economic sugar high fades. But the market, which is like the smartest person in the room, already knows that. To us, the uncertainty is not over the direction of revenues for each company but the magnitude of the deceleration. Understanding which companies are the most likely to see the sharpest decline in revenue growth and which are the most likely to be resilient will be key.

In an inflationary period such as the one we have experienced over the past year, almost all companies have been able to raise prices, driving impressive revenue growth. But that isn't pricing power. It's simply a step that must be taken to keep up with rising costs. These days everyone is raising prices, and consumers have an easier time accepting them psychologically in large measure because they have extra cash in their pockets as a result of the policy response to the pandemic. And that makes it harder for investors to distinguish between companies that are taking advantage of cyclical forces and those that can command higher prices due to high levels of demand for products or services that their customers find superior and are willing to pay for.

In other words, markets become less efficient in times like these. What investors ultimately care about, the true free cash flow growth differential, is only learned after the fact. Markets become volatile when forced to correct for faulty cash flow projections. Today, investors face the significant risk of owing financial assets where cash flow growth proves illusory because their recent profit strength was stimulus-driven rather than something more durable.

Cost considerations

Regarding costs, we're thinking about them two ways.

Any costs that weren't "nailed down" during the crisis were quickly ripped out by CFOs. While postpandemic life may be further off than we'd like, most expenses will return, hitting income statements. But how quickly will these legacy costs come back online?

Costs related to environmental, social and governance (ESG) issues are another consideration. For years, less-competitive companies were able to disguise below-average operating margins and cash flows with unsustainable practices carried out at the expense of various stakeholders. But those days are likely over. The game-changer isn't pressure from regulators or special interest groups. It's pressure from investors. Today's discretionary providers of capital are demanding change, and in some cases change will be expensive. Some companies will be able to shoulder the burden while others will find it difficult. In Europe, for example, many banks have recently pulled short-term funding from polluting utilities, a clear sign that the free ride is over. Given the level of corporate indebtedness today, ESG strikes me as an underappreciated material risk, particularly by corporate bond investors.

An underwhelming outlook

I'm not suggesting a bear market or correction is on the horizon. I don't have that type of clairvoyance, nor do my strategist peers (though some think they do!). Anyway, that's not how we think about investing.

Looking ahead, we expect high-priced financial assets that deliver underwhelming fundamental performance to be repriced. When valuations are high, the market's tolerance for disappointing data (even if the miss is small) is low. Conversely, stocks and bonds of companies that meet expectations may be in short supply and outperform by earning a scarcity premium.

Combined with the poor risk/reward tradeoff in many financial assets today, discretion has the potential to be worth more than it has in a very long time. It's a time for patient, skilled investors.

After all, as the saying goes, it's the second mouse that gets the cheese.

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