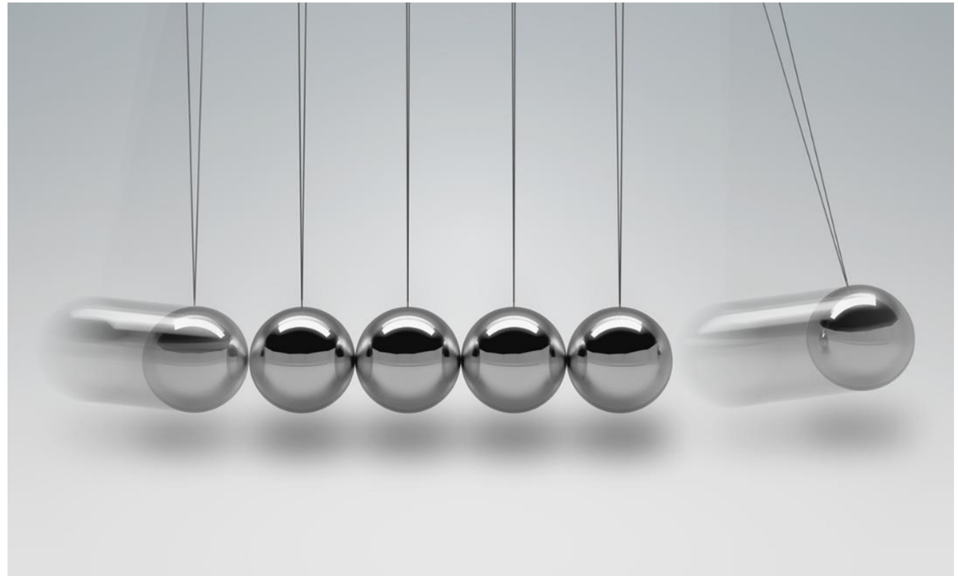
Viewpoint



Quality Growth: Is the pendulum swinging back?

2022 has been off to a volatile start and markets are likely in for a continued rough ride this year as the possibility of a recession looms over several countries. If it occurs, a recession will be caused by various factors including a decline in government spending, continuing supply-side problems connected with Covid-19, and sharply higher energy prices caused, in part, by the war in the Ukraine and subsequent energy boycotts by western nations. The recession, however, will result primarily from substantially higher interest rates, as well as from the "quantitative tightening (QT)" that central banks must impose to kill the high-inflation wave currently confronting them.

Ideally, the world's central bankers could bring down the high-growth economy of 2021 more softly. In 1994, Federal Reserve Chairman Alan Greenspan did just that for the US economy when he raised rates sharply (+300 bps) in anticipation of higher inflation. He succeeded in both cutting inflation and avoiding a recession. But Chairman Greenspan's success was an anomaly in the post-World War II period as the US Federal Reserve has rarely been able to engineer a soft landing[1]. It will likely fail again this time around as it has waited far too long to take action, and the US may enter a recession by year's end or early-'23.

Abroad, recession concerns have increased considerably in Europe due to sharply higher energy prices and worries about shortages. In Germany, which derives ca. 25% of its energy supplies from Russia, businesses realize that if rationing occurs, they are last in line. Many expect that their firms would close and they would need to furlough their workers[2]. German businesses expect a dire situation in regard to future economic activity (Figure 1)[3].

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[1] See WSJ, "Hot Economy, Rising Inflation: The Fed has Never Successfully Fixed a Problem Like This". https://www.wsj.com/articles/inflation-jobs-fed-recession-economy-11650294297?mod=hp_lead_pos9
[2] Chazan, Guy; Miller, Joe; and Arnold, Martin, "Worst crisis since the second world war", FT, 21 April 2022.
[3] ZEW, Finanzmarktreport, "Konjunkturerwartungen verharren auf niedrigem Niveau", May 2022, zew.de/pub.

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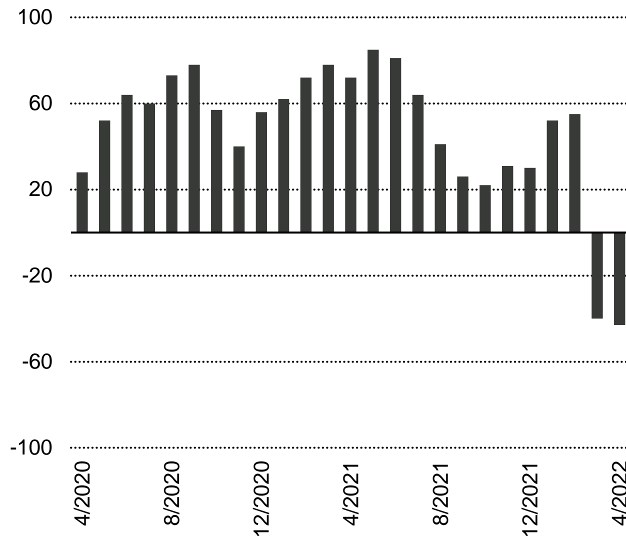
Figure 1: Economic expectations for Germany



Balance of positive and negative assessments of the economy in Germany in six months.
Source: ZEW – Leibniz Centre for European Economic Research

China may avoid recession but will see sharply lower growth this year vs. 2021's 8% decline caused in part by severe COVID-induced lockdowns of some major cities, including Shanghai and Beijing. The latest expectations are for GDP growth in China of 5% in 2022, and 5.2% in 2023[4]. But the longer the lockdowns last, the more likely it is that at least 2022's growth expectations will be pared back.

In addition to being caused by more cautious business and consumer expectations, a sharp slowdown, or recession will be precipitated by higher unemployment. Economies will lose jobs as interest-sensitive sectors such as housing, automotive, and retailing see slower activity and declining sales and profits. Job losses will lead to slower consumer demand, the main driver of GDP in almost all countries. The overall fall in demand is hard on all businesses, but particularly on cyclical ones which, as their name implies, move with the economic cycles. When times are good, their earnings explode upwards. When times are bad, their earnings decline – oftentimes turning negative – as the economy rolls over.

In addition, a recession caused by higher interest rates is tough on high-growth, highly-valued companies, that is, those with plenty of enthusiasm about the future, but little earnings today. These areas of the market did relatively well over the past several years as central banks maintained ultra-low interest rate regimes and governments supplied huge stimulus packages to their economies. But those days are over as inflation has exploded. The same banks have now recognized that their easy money policies have been in place too long, and they are now sharply paring back the money supplies. Recession, with a few exceptions such as China, will likely follow in many leading economies.

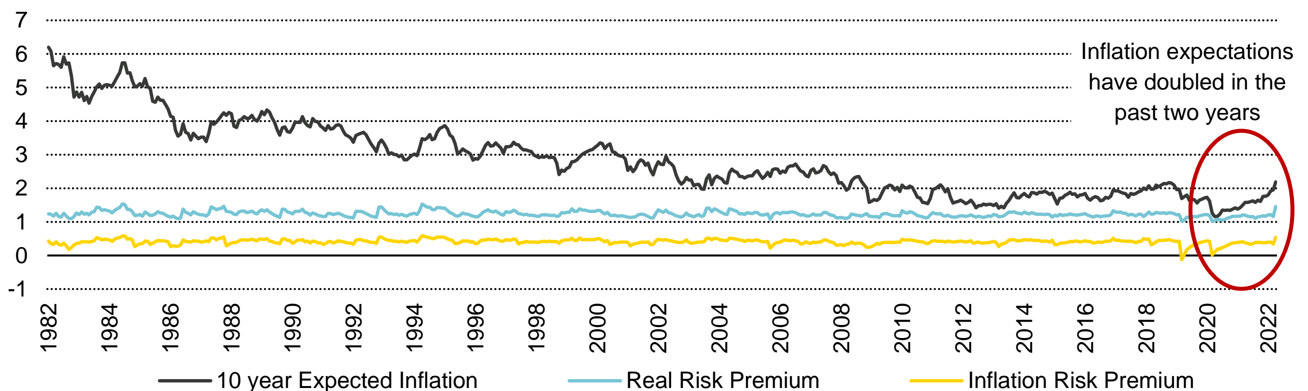
In this new environment, Quality Growth companies – out of favor the past several years – should begin to shine again. These companies enjoy relatively high operating margins due to the economic moats around their businesses. They have the ability to raise prices in inflationary times and can provide consistent earnings in such periods. We believe they are the slow but ultimately successful tortoises of the long foot race investors engage in to beat the overall market.

Inflation and the global growth slowdown

How did the global economy get into its current situation? It started with price increases – inflation – becoming endemic in many countries. Two years ago, central bankers were dealing with Covid-19 and the subsequent lockdowns. The effects on economies around the world were sharp as recession ensued, but central bankers in the US, Europe, Australia, Japan, and China responded with zero or near-zero interest rate policies, as well as quantitative easing to provide liquidity to governments and consumers. Economies quickly rebounded, in fact they went on a tear, as trillions of dollars and euros and yen were pumped into the system. The result was the classic one of "too much money chasing too few goods" and prices started to rise.

In the US, looking back some 40 years, we have not seen long-term inflation expectations move up as much, nor as quickly, as they have over the past two years. Since April 2020, 10-year inflation expectations have doubled, rising by over 100 bps from 1.16% to April 2022's 2.19%. And with March's inflation increasing at an 8.5% rate vs. March 2021[5], one can expect long-term inflation expectations to continue to rise.

Figure 2: 10-year expected inflation and real and inflation risk premia



Source: Federal Reserve Bank of Cleveland calculations based on data from Blue Chip, Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank of Philadelphia, Federal Reserve Bank, Haver Analytics, and the model of Haubrich, Pennacchi, and Ritchken, 2012. "Inflation Expectations, Real Rates, and Risk Premia: Evidence from Inflation Swaps." Review of Financial Studies, 25(5).

[4] Kihara, Takeshi, "China GDP forecast to grow 5% in 2022: Nikkei survey", NikkeiAsia, 06 April 2022.
[5] Consumer Price Index, March 2022, released 12 April 2022, US Bureau of Labor Statistics, https://www.bls.gov/cpi/.

Things are, unfortunately, not better elsewhere in the world. In Germany, March CPI was +7.3%, with housing & energy rising 8.8%, and food and non-alcoholic beverages +5.9%[6]. For the Euro-area as a whole, consumer inflation rose 7.5% in March. Again, energy rose the most (+44.7%), followed by food, alcohol and tobacco[7]. India's CPI (retail) inflation increased to 6.95% in March, and the Reserve Bank of India expects it to finish the current financial year at 5.7%[8]. A year ago, policy makers claimed that inflation was "transitory". But the aforementioned supply bottlenecks, and the war in the Ukraine have conspired to dash their hopes that inflation would remain under control.

Options have narrowed as inflation has continued to increase. So, central bankers are responding by withdrawing liquidity, in effect, turning off the money taps. The US Federal Reserve announced a rate increase of 25 bps in March and has signaled that they will increase a further 50 bps in May, with more increases to follow. One typical estimate is for increases of an additional 250 bps (from March's level) to bring the Fed Funds to 3% by early-2023[9]. JP Morgan's CEO Jamie Dimon sounded even more hawkish on rates in response to a question on Fed tightening during a call with analysts in mid-April:

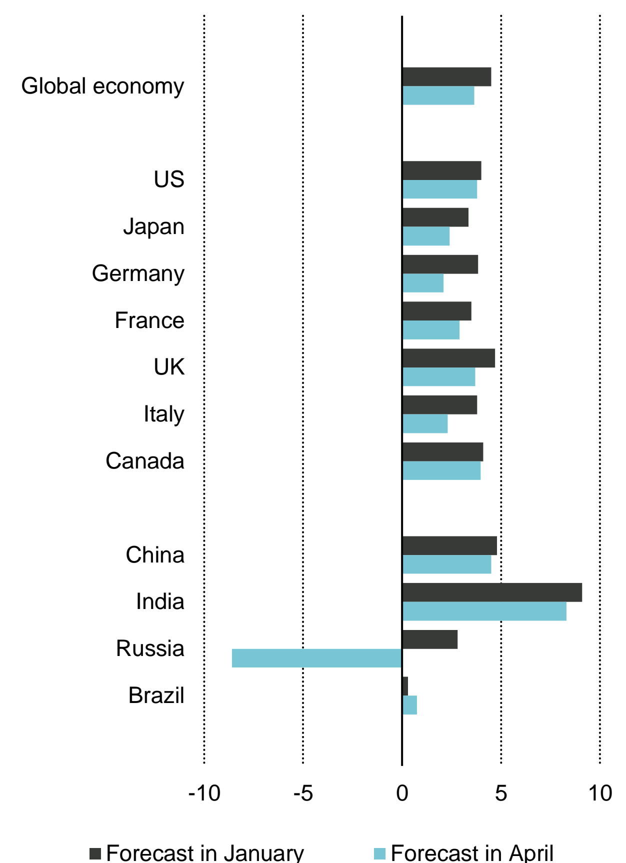
> *"So I think the implied curve now is like 2.5% at the end of the year and maybe 3% at the end of 2023. Look, no one knows. Obviously, everyone does their forecast. I think it's going to be more than that, okay. I'll give you a million different reasons why because of inflation, and we just talked about deposits. And we've never been through, ever, QT like this. So this is a new thing for the world."* [10]

The ECB has hesitated to forcefully react, yet – Chairwoman Christine Lagarde noted in March that quantitative tightening had begun, thus providing the bank "extra space" before raising rates. The bank forecasts 5.1% inflation in 2022, but only 2% in 2023, suggesting Mme. Lagarde and her staff still hope that inflation is "transitory" [11]. Money markets, nevertheless, expect a 50-75 bps rise by year's end from the ECB, with inflation at current levels[12].

As night follows day, we are seeing cuts to global growth forecasts as economists realize that their rosy scenarios of steady growth in 2022-23 have become much thornier. In April, for instance, the IMF announced that their new forecast for global GDP growth for 2022 would be 3.6%, .8% lower than the growth they had forecast just three months earlier and 1.3% lower than six months ago.

The IMF's chief economist Pierre-Olivier Gourinchas stated that, "we're facing a slowdown in growth (and) facing elevated inflation". He was asked by an FT reporter about "stagflation" – a high inflation environment with no GDP growth – and coyly responded that, "I want to be a little bit careful about whether we really want to put ourselves in a frame of mind of the stagflation of the 1970s" [13]. Clearly, the idea that growth will fall sharply as interest rates increase, while inflation may hang on much longer, is the worst of both worlds. Mr. Gourinchas and other economists and financial policy leaders would rather we did not countenance such a prospect.

Figure 3: The IMF cuts economic growth forecasts
Annual GDP growth in 2022 (%, selected countries)



Source: IMF, Financial Times.

[6] CPI, Germany, March 2022, DeStatis, Statistisches Bundesamt, www.destatis.de
[7] Euro area annual inflation up to 7.5%, 01 April 2022, Eurostat, euroindicators, ec.europea.eu/Eurostat.
[8] "Retail inflation spikes to 6.95% in March", The Indian Express, 19 April 2022, Indianexpress.com.
[9] Rissmiller, Don, "What if Macro Policy Can't Balance Supply & Demand?", Strategas, Economics Report, 18 April 2022.
[10] JP Morgan, 1Q22 Financial Results, Earnings Call Transcript, 13 April 2022, jpmorganchase.com/content
[11] ECB, "Meeting of 9-10 March 2022", 07 April 2022, ecb.europe.eu
[12] "ECB has 'extra space' before first rate hike, Reuters, 17 March 2022, reuters.com.
[13] Giles, Chris and Smith, Colby, FT, "IMF cuts global growth forecast to 3.6% as Ukraine war hits neighbours hard", 19 April 2022.

Whither momentum and value?

In the higher-inflation, slower-growth scenario outlined above, investors must tread a more cautious path. Figure 4 shows how different factors have led to better performance over the past 17 years[14].

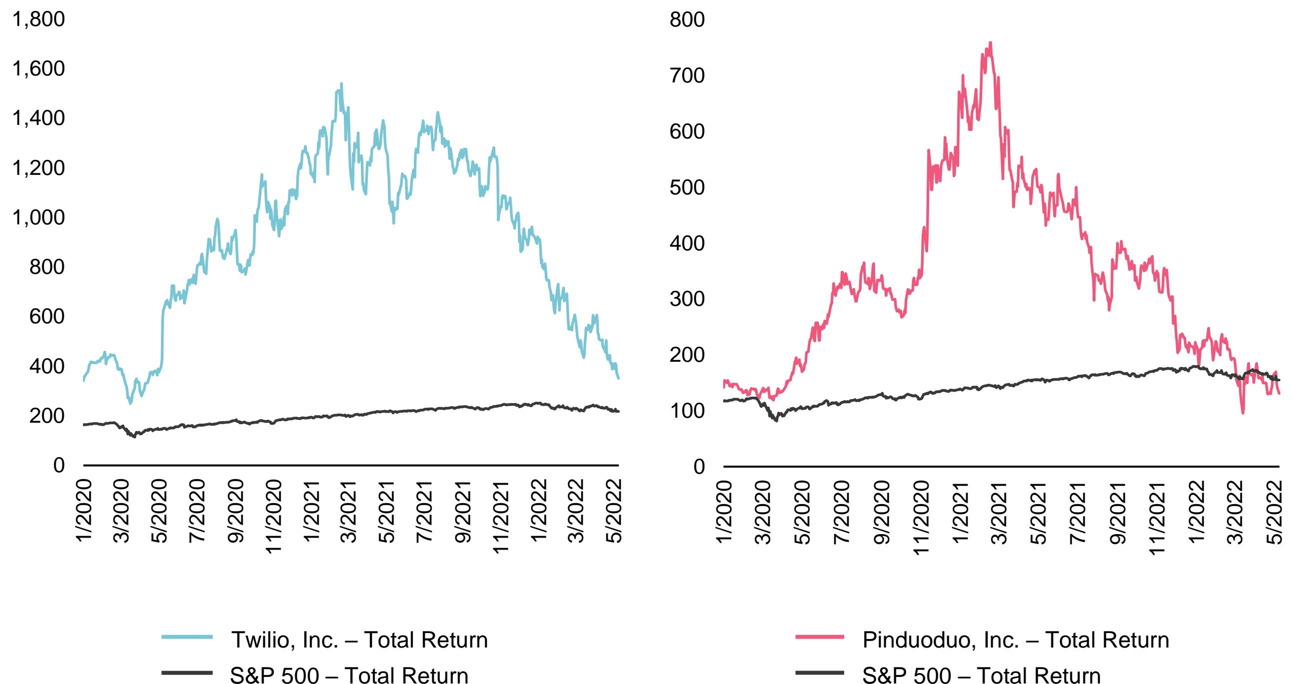
Figure 4: Factor performance

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Quality	Volatility	Volatility	Quality	Volatility	Volatility	Momentum	Momentum	Value	Growth	Quality	Growth	Volatility	Value	Value
Yield	Value	Growth	Yield	Value	Momentum	Value	Quality	Yield	Volatility	Momentum	Volatility	Growth	Momentum	Yield
Momentum	Growth	Value	Momentum	Growth	Value	Yield	Growth	Volatility	Quality	Market Cap	Quality	Momentum	Quality	Market Cap
Market Cap	Yield	Momentum	Market Cap	Yield	Growth	Growth	Market Cap	Quality	Momentum	Yield	Value	Market Cap	Market Cap	Momentum
Value	Quality	Quality	Growth	Market Cap	Yield	Quality	Yield	Market Cap	Market Cap	Growth	Market Cap	Quality	Yield	Quality
Growth	Market Cap	Yield	Value	Quality	Quality	Market Cap	Volatility	Momentum	Yield	Value	Yield	Yield	Growth	Volatility
Volatility	Momentum	Market Cap	Volatility	Momentum	Market Cap	Volatility	Value	Growth	Value	Volatility	Momentum	Value	Volatility	Growth

Source: Style Analytics as of 30 April 2022.

One notes from the chart that over the past four years momentum-growth companies did well, but lost favor in 2021-22 (year-to-date) as value companies became more attractive to investors. One should expect that as rates continue to rise, momentum-growth companies, which typically have little immediate earnings to fall back on, will be increasingly shunned. This is because the earnings of such companies are forecast well into the future when their products or services should provide positive margins, but then must be discounted back to present value using the prevailing discount rate (the 2-year UST bill's yield), or a company's weighted average cost of capital (WACC). In times of rising rates, smaller companies, or those with little or no earnings – oftentimes momentum-growth ones, can see their WACC increase considerably, thus leading to a decline in projected valuations discounted to today.[15] Classic examples of this group of companies include software and biotech companies in the US, and newer consumer cyclical companies in China, as illustrated below in Figure 5.

Figure 5: Twilio and Pinduoduo Inc. (ADR) returns vs. S&P 500



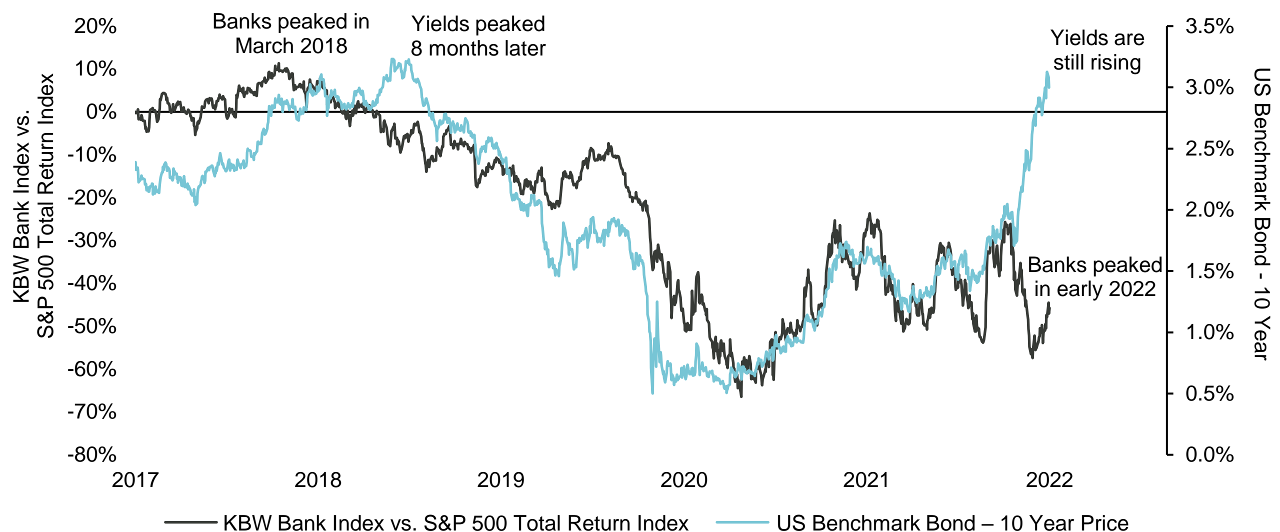
Source: FactSet as of 9 May 2022.

[14] Style Analytics, March 2022. Ranking reflects country- and sector-adjusted relative performance vs. Style Analytics' Developed Markets index, rebalanced monthly.
[15] White, Rich, "DCF Valuation: The Stock Market Sanity Check", Investopedia, 21 March 2022. A simple example shows that an increase in WACC from 8% to 14% leads to a valuation decline of 27%.

And what about value? How do companies such as builders, engineering firms, automobile manufacturers, money-center banks, and energy and materials companies fare as interest rates rise and economies slow? Not surprisingly, as rates rise, many of the companies in these sectors should also start to underperform the general market as investors fret about a growth slowdown. In fact, the shares of several of these sectors have already started to do so.

US banks, for instance, are contending with mortgage rates that have doubled over the past 18 months to approximately 5.1% in late-April, leading to lower loan growth for the housing sector. Investment banking businesses have slowed due to market volatility and higher interest rates. Banks see the writing on the wall and are increasing their credit reserves for more difficult times to come. Investors, meanwhile, are weighing the factors pressuring banks, looking at higher interest rates and the concomitant lower growth forecasts, and deciding it is not a good scenario for bank stocks. Bank shares peaked in January-February of this year and have lately been declining sharply. They tend to precede a downward move in interest rates, and the last time they peaked in 2018, interest rates continued to rise for 8 months.

Figure 6: 10-year yield vs. banks relative to the S&P 500



Source: FactSet, Bloomberg, as of 11 May 2022.

Other sectors that are economically sensitive are not faring much better. Consumer discretionary companies, such as automobiles, are seeing their stock prices fall this year as investors worry about lower sales and profits. Whether it is a US automaker like Ford (-22% year-to-date in local currency),[16] or a European one like Volkswagen (-12%), many are suffering. Elsewhere, many traditional industrials are also weak, including Siemens (-21%), Alstom (-31%), GE (-3%), Ingersoll-Rand (-23%), or Mitsubishi Electric (-5%). Defense companies, however, are faring better.

The two last holdouts in the value space are the energy and materials sectors. But commodity prices are not a one-way bet, and production is bound to increase in the US, Canada, and within OPEC countries as oil prices remain at ca. $100/ barrel. The old adage, "the cure for high energy prices is high energy prices" should come into force, bringing down the price of oil and gas, and hence the valuations of energy companies. Materials are harder to call in total because it is a diverse group where some economically sensitive metals/ minerals such as copper or steel may suffer a great deal, while others supplying to such sectors as the nuclear (uranium) or EV (lithium, cobalt, nickel) ones may do relatively well.[17] In the medium and longer-term, however, commodities are cyclical and should eventually fall in price as supply exceeds demand. Investors who own companies in the sector must keep one hand poised over the "sell" button.

Quality growth as the last man standing

How will this investment roller coaster play out for long-term equity investors? As noted above, over the past several years we have seen investors generally shun quality and quality growth companies in favor of other styles. First, there was the rush into momentum growth strategies as interest rates were cut to zero in Spring 2020, and the lockdown-induced recession quickly ended. Investors gave companies with little or no earnings sky-high valuations on the notion that money was free, thus discounting future earnings to present value became a simple game. Next, in 2021, came the "great rotation" away from growth and into value strategies. Investors saw a window for higher earnings for cyclical companies, including energy and materials companies, industrials and money-center banks, and bid up stock prices in these sectors – see Figure 6 on US banks.

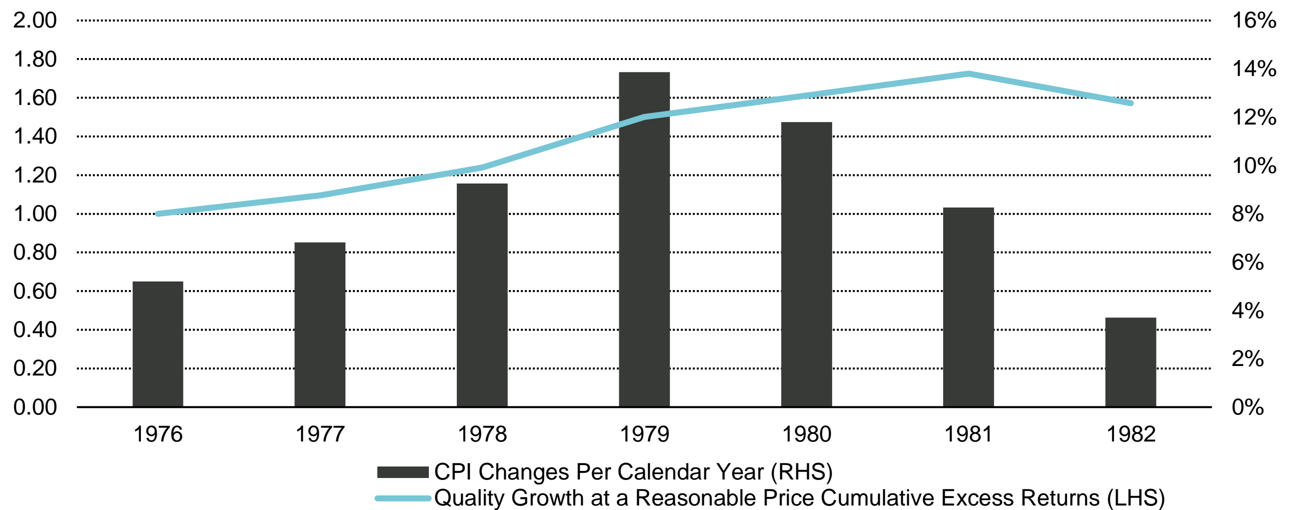
Fast-forward to today and many of these value companies are rolling over. Blame it on inflation, blame it on Covid-19's resurgence in China, blame it on Vladimir Putin, the world has become a less certain, indeed scarier place to invest. With the exception of the energy and materials sectors, the value trade seems to be running out of steam.

[16] FactSet, 20 April 22.
[17] See "Rivian CEO Warns of Looming Electric-Vehicle Battery Shortage", WSJ, 18 April 2022, for a view on the EV industry's needs: https://www.wsj.com/articles/rivian-ceo-warns-of-looming-electric-vehicle-battery-shortage-11650276000?mod=Searchresults_pos3&page=1

Thus, like the end of a long evening of revelry, this decline in the fortunes of both momentum growth and value companies, leaves only the Quality Growth investors, in our opinion, still standing. They are the ones invested in companies with strong businesses earning consistently high margins. They own companies with the power to increase prices during inflationary periods. Their companies have relatively low debt levels and can withstand higher interest rates more easily. They will see relatively benign comments from their companies' CEOs about current and future business prospects. In short, they should sleep relatively well at night.

Members of the consumer staples sector, a traditional source of high-quality, dependable growth names, began reporting their quarterly results in April. Two food/personal care companies, Nestle and Proctor & Gamble, informed investors they had increased prices 5% each. Heineken, the eponymous Dutch brewer, announced that it had increased prices by 5.2%[18]. Quality companies tend to have pricing power and can raise their prices to protect their profit margins. Investors reward such companies by buying their shares during inflationary times, as happened in the late-1970s when inflation raged through economies – see Figure 7.

Figure 7: Quality growth outperformed in past periods of inflation



Past performance is not indicative of future results.
Source: Credit Suisse HOLT, Bloomberg, Axioma, St. Louis Fed. Data as of 15 March 2022. Note: The Quality Growth at a Reasonable Price universe is defined by Credit Suisse HOLT as: The top 50% of companies measured by Quality and Growth scores, and the top 40% of companies measured by HOLT's proprietary valuation score.

Conclusion

The past several years have witnessed a whipsawing of the markets. Investors have moved from owning growth-oriented companies in 2018-19, to higher-growth momentum companies in 2020 with the "zero-rate" monetary policy as a backdrop, to value companies as investors anticipated a sharp economic rebound post-Covid-19 lockdowns. With inflation rising sharply, and interest rates quickly increasing from very depressed levels, we have entered a new phase, one where the pendulum may swing back to Quality Growth, with its emphasis on companies with high margins, pricing power, low debt levels, and consistent earnings growth.

[18] Evans, Judith, "Nestle boosts sales with 5% increase",

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