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INVEST WITH CONFIDENCE

TAKING ADVANTAGE OF THE FEAR AND UNCERTAINTY

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Global markets are certainly showing plenty of fear and uncertainty right now, as the raging bull narrative has turned back to one of an aging and fading bull. One primary reason relates to concerns over inflation, trade wars and the end of monetary stimulus. We are skeptical on the "return of inflation" narrative, despite the year-on-year rise in price data and the markets' elevated concern. Indeed, volatility around the direction of inflation and general macro concerns in markets have been offering us a chance to upgrade and improve our holdings, which is a positive by-product of this more risk-off environment.

SHOULD WE BE WORRIED ABOUT INFLATION?

Last year, inflation remained unusually muted versus expectations, allowing central bank monetary policy to remain loose. This helped dial down volatility and ramp up animal spirits for the first time in almost a decade. This year, however, we have seen inflation move from a strategist byline to a cycle-ending scenario, if you choose to believe the bears. Indeed, louder and more confident voices are articulating that wages, prices, and politics (more on this later) will drive up inflation and interest rates and finally end this equity cycle.

For us, given that inflation is important for sentiment and market fundamentals, we are closely analyzing not just the magnitude of inflation but also the constituent parts of its origins. Cyclical inflation is showing itself for the first time in a while (Figure 1), but the secular debate is a crucial one, in our opinion, because so many of the secular forces we see today actually sit outside the traditional economic frameworks that economists like to use.

WHY DO WE DIFFER?

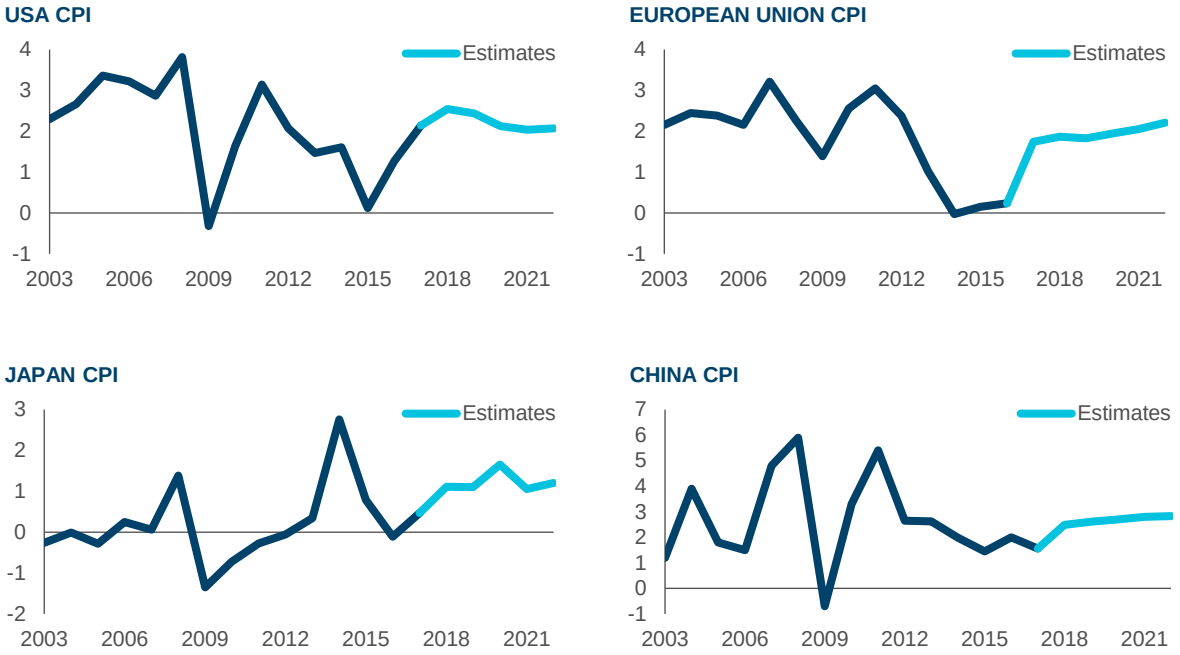
On the cyclical front, while U.S. wage growth exceeding expectations might be perceived by some as a sign that economic growth is maturing and broadening, the market's reaction to accelerating wage inflation actually tells you of investors' dislike of regime change (higher inflation and what that might imply) (Figure 2). It also implies a dislike for the prospect of higher disposable incomes, higher consumption, and broader wealth creation. Unfortunately, these cyclical forces are likely to keep playing out in the near term, so volatility is likely to remain with us in the coming months for as long as the market keeps perceiving inflation as "bad."

ECHO, ECHO, ECHO…

We acknowledge that there is an echo effect playing out in inflation terms, but inflation is, of course, a point-in-time comparison that depends on the base level of a year ago. That base level was unusually low in Q1 2017 as a muted global economy and uncertainty over U.S. politics, and specifically the rules of engagement for companies, reined in spending and investment. A year on, the picture is very different as synchronized global growth, strong profits growth, and clarity over taxes (lower for nearly all) have lifted sentiment and the willingness of corporates to imagine an economic outlook that implies more investment in labor and growth capital expenditure.

Figure 1: **Inflation Data—a Talking Point Becomes a Market Mover**

As of April 30, 2018

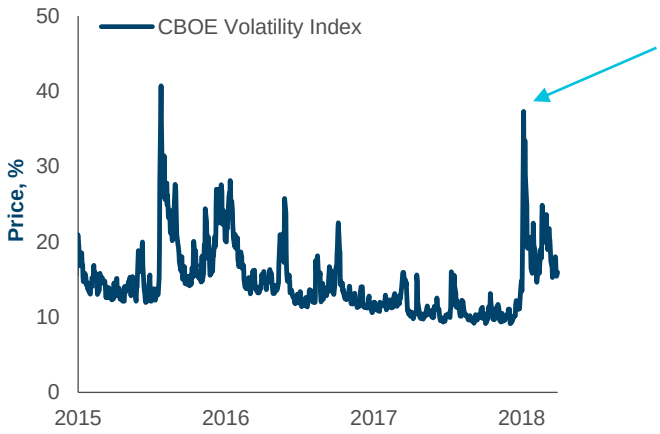


Sources: IMF World Economic Outlook and FactSet Research Systems Inc.

Figure 2: **Volatility and Regime Change**

Volatility returns in 2018. CBOE volatility index 2015–2018.

As of April 30, 2018



Source: FactSet Research Systems Inc.

- "Positive" wage surprise in January's U.S. jobs report gave a strong indication of the market's dislike for regime change and its concern over life after QE.
- Some shift in volatility is natural as the market digests a new regime typified by a higher degree of complexity when compared with recent quarters.
- The pace and origin of inflation catalysts matter a great deal as we look out. U.S. politics appears increasingly inflationary on the surface, at a point when inflation is rebounding cyclically.
- Longer-term structural forces still appear disinflationary, setting up a fight for superiority on the inflation front, around which consensus is very fractured.

DOES AN INFLATION ECHO TURN INTO A CRESCENDO?

As stated, the outcome of the inflation fight that will play out this year is much more complex than an economics textbook would imply. Economic textbooks speak of the Phillips curve and how a certain level of unemployment leads to a certain level of wage inflation. While the unemployment/wage growth relationship remains cyclically important, we see some very strong structural forces vying for superiority that are influencing inflation both negatively and positively.

Think of it this way in boxing analogy terms. We have in one corner structural disinflation being driven by technology (think of Amazon's impact on retail prices, Spotify's on music prices, the adoption of automation/robotics, and the impact for manufacturing jobs and wages), demographics, and globalization. We would also argue that the shift away from manufacturing (most notably in the United States), as well as a shift away from commodity consumption (most notably in China), should be factored into lower inflation expectations.

Meanwhile, over in the other corner, we have in tandem with the cyclical recovery in the U.S., economic policy, which, once again, looks very inflationary on the surface. Tax cuts for corporates and individuals—tick; cancellation of the Iran nuclear deal pushing up oil prices—tick; a trade war with China/everyone—tick. Although we continue to believe the risk of a full-blown trade war is low, it is a risk we are monitoring, given that it would inject "bad" inflation into the global economy.

We all know politics and politicians have become more unpredictable, however. Wealth inequalities have grown (primarily down to the wage cycle being so anemic over the past decade). But our base case remains that the potential tipping point for inflation of a full-blown trade war remains in no one's interests.

While wages are rising and unemployment is low, the prospect of a broad breakout to the upside is also not our central scenario. Our view remains that inflation is likely to peak in the middle of 2018 and leave an uglier version of Goldilocks behind—stability and solid growth, but absent the positive surprise factors of 2017 and with more volatility attached. That, however, is an environment we can work with as equity investors. In particular, as growth investors, uncertainty and volatility allow us to be active and nimble (Figure 3).

Figure 3: **What Does Deflationary Progress Imply for Investors?**

Source: T. Rowe Price.

SECULAR CHANGE AND THE VALUE/GROWTH QUESTION

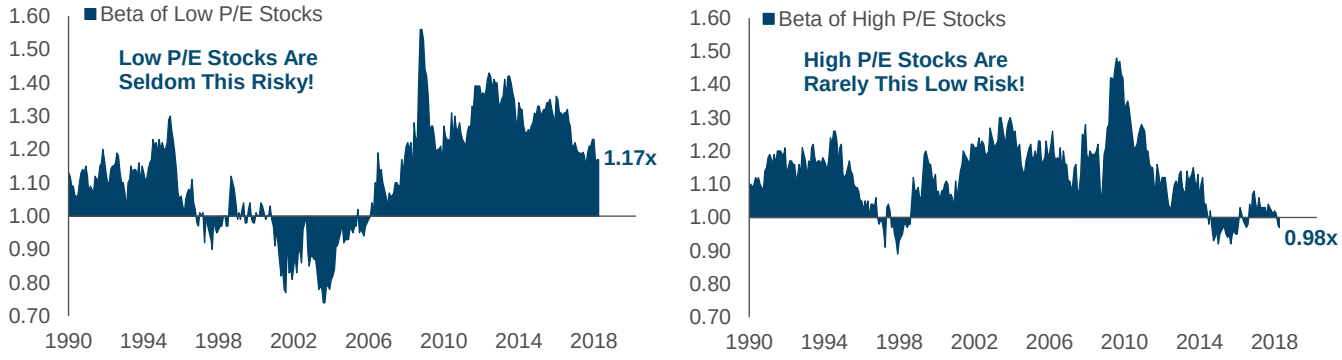
One notable impact of this era of secular change for equity investors is that in a world of lower economic growth, growth companies have outperformed significantly and assumed a more favorable reputation with many investors. This is intuitive, given the nature of a scarce commodity (growth) and that price investors are willing to pay for companies that can create positive shareholder returns in a more growth-challenged world.

However, it is also notable that growth stocks have been changing from an absolute and relative volatility perspective. Figure 4 demonstrates this point and shows that while higher P/E stocks have taken on lower beta characteristics versus history, lower P/E stocks have seen their beta characteristics rise significantly since the GFC. We believe this is, in part, because of the increasingly cyclical nature of "value," especially in market segments such as financials, energy, and materials. Leverage adds to this volatility shift, with many successful growth innovators amassing large positive cash balances, while debt has increased in the value complex, in an era of cheap and available financing.

This evolution is certainly worth noting from a risk/return perspective, with growth assuming better and more defensive drawdown characteristics in recent years when compared with value. Time will tell whether this is due to transitory investor behavior; but our perspectives on structural change inform us that there is also real change occurring that which is shifting the nature of markets and stocks.

Figure 4: **Now That Is New!**

As of April 2018



Source: Cornerstone.

SO, WHAT'S THE STORY?...LONG-TERM GLORY?

We remain focused on being on the right side of change, investing in companies that can grow in what we believe will be a lower-growth world. We have reiterated this point many times, but a low-growth world does not imply a lack of change or progress. In many senses, the pace of change still feels furious to us as industries grow, with the winners winning big and the losers facing an uncertain future.

What we are doing is taking a more balanced approach, as many of the cyclical areas that were structurally depressed (financials and industrials) have rebounded in response to rising global growth expectations. Meanwhile, information technology and other areas that have been clear market beneficiaries have become a much more crowded space, which poses a challenge in certain segments of the market.

So we are, therefore, being very specific about the stocks we own and remain committed to our investment framework, which focuses on identifying and investing in high-quality companies where we have insights about their improving economic returns for the future. What volatility has allowed is a refreshing upgrade to our holdings, where macro fears have shifted stock prices unnecessarily.

Looking at the big picture, we remain confident in the long-term outlook for companies that are on the right side of change. Are we being watchful for risks, however, and are we open to changing our mind? Absolutely.