



Seize the opportunities in a new era for global equities



From the Field
December 2023

Key Insights

- After an extended and unusual period of low inflation and ultralow interest rates, we now appear on a new equilibrium path. One where inflation remains sticky and interest rates are higher.
- Being on a different path will offer different opportunities in the future. Having a broad definition of growth flexible enough to focus on new areas of the market will be key.
- Our investment framework remains focused on identifying quality companies where we have insights into improving economic returns in the future but we do not pay too much for them.



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In 2023, investors have had to contend with multiple headwinds that could have combined to derail equity markets. Among them, a regional banking crisis in the U.S., a severe slowdown in China, and wars going on in Ukraine and the Middle East. Add to that 500 basis points of cumulative interest rate increases, a deeply inverted yield curve, and a litany of other gloomy economic indicators. Yet, while there have been bouts of volatility, equity markets have held up surprisingly well. Large-cap technology companies—in particular the so-called Magnificent Seven (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta Platforms, and Tesla)—have fared even better.

“ ...Fed rate hikes have been nonbinding and haven’t impeded the economy in a material way.

– David Eiswert
Portfolio Manager

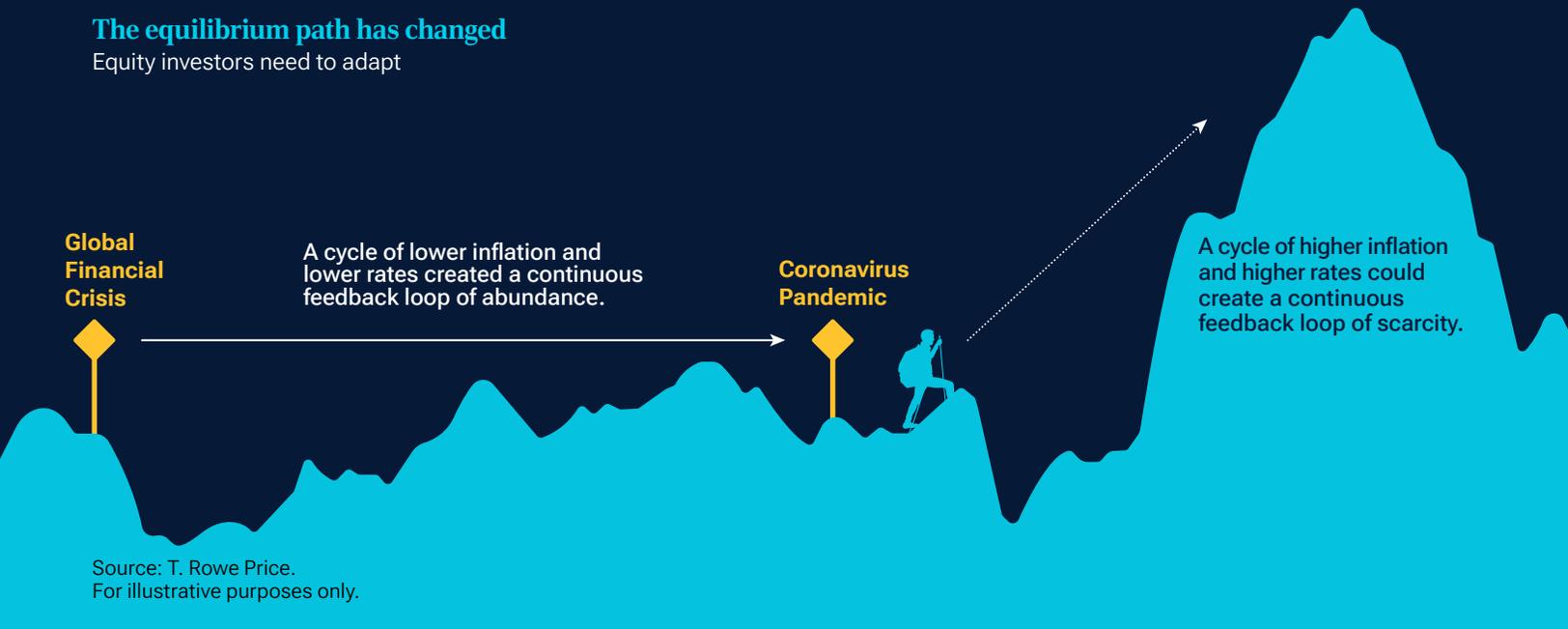
What’s behind the apparent contradiction? In the U.S., economic growth has consistently exceeded expectations, pushing out a highly anticipated recession. We also haven’t experienced a “normal” credit cycle. In the

U.S., companies and consumers alike have termed out their debt over the last few years at extremely low levels of interest rates. Fiscal policy, meanwhile, has bolstered the economy through infrastructure spending, in numerous cases for geopolitical considerations, and in stimulus measures to help during the coronavirus pandemic. Consumers have reaped the rewards of higher savings and accelerated real wage gains, while at the same time locking in low rates on their largest expense—mortgages. Simply put, the Fed rate hikes have been nonbinding and haven’t impeded the economy in a material way. How long this will last is an entirely different question, but it is how we got here today.

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The equilibrium path has changed

Equity investors need to adapt



A new equilibrium path for equities?

Our view is that we are operating in a different environment from the one that supported equities for much of the period after the global financial crisis. The equilibrium path has changed—and equity investors need to adapt.

Between the global financial crisis through to the coronavirus pandemic, the equilibrium path was deflationary—low inflation created even lower inflation. This was demonstrated in the energy sector as the low cost of capital and technological revolution of fracking led to increased drilling and more oil being sold at lower prices. A cycle of lower inflation and lower rates created a continuous feedback loop of abundance. The dynamic was not isolated to the oil and gas industry. It extended across sectors and economies and created a paradise for growth investing—especially for those investing in duration.

The cycle has shifted, and we now appear on a new equilibrium path. One where we see inflation remain sticky, despite recent falls, and with interest rates being maintained at higher levels for longer.

The global financial crisis shocked us onto a lower inflation and lower rate path. Now, the pandemic, fiscal policy response, and supply chain problems have shocked us onto this new path—one that is likely to lead to a continuous feedback loop of scarcity.

Again, we highlight the oil and gas industry, where even though oil prices have risen solidly since the summer 2023 trough, rig counts in the U.S. are falling. Why? Because rising financing costs; labor shortages; higher transportation costs; environmental, social, and governance (ESG) pressures; and industry consolidation have all pushed the oil cost curve meaningfully higher. This requires oil prices to be higher to incentivize companies to accelerate drilling.

These dynamics set the scene for inflation to remain sticky, alongside higher interest rates, until we get shocked off this path. This would require a recession and high unemployment, but that is not predicted in the near term. With the U.S. Federal Reserve unable to create a credit cycle, but also unlikely to aggressively cut rates leading into an election year, we expect higher short-term rates for longer until the excess liquidity from the pandemic is pulled out of the system.

Implications of a new equilibrium path

Being on a different equilibrium path requires investors to adapt and not rely on past growth investing strategies of buying technology and duration and forgetting about the rest. Instead, investors should consider what is appropriate in an environment that is vastly different from when rates were zero.

This environment, however, will yield new opportunities, but to find those, an investment framework that is malleable enough to readjust is key. Having a broad definition of growth will be crucial to allow the flexibility to focus on different areas of the market where one can identify companies that are providing better earnings growth. Said another way, you don't need to be waking up every morning hoping that the Fed will start cutting rates. Instead, it will be important to find insights regardless of industry or geography. As investment managers, we are not interested in changing our stripes but in maintaining our focus on finding companies where we can identify improving economic returns without paying too much for them.

AI²—Artificial intelligence and artificial incretins (GLP-1s)

At the same time, as we have shifted onto a different path, we have also seen two fascinating developments: the potential for artificial intelligence (AI) and artificial incretins. AI has been a significant talking point and market driver in 2023 and a defining theme for investor returns given the narrowness of equity markets. Since November 2022, when Open AI launched ChatGPT, companies have been in an “arms race” to acquire new AI capabilities and refine existing ones. We liken the current AI cycle to the previous buildout of optical fiber to support the internet at the turn of the millennium and the follow-on cycle of investment in wireless communications.

We are acutely aware of how these cycles play out, but we believe we are still in the initial stages of infrastructure buildout. NVIDIA has a dominant industry position currently and, with it, pricing power. We believe this will continue to be driven by supply constraints and huge levels of demand from companies wishing to build AI applications.

Another innovation with seismic potential is artificial incretins, specifically GLP-1 agonists that were originally developed to treat Type 2 diabetes. These are having a profound impact on weight loss and the perception of obesity as a disease. Obesity could become one of the largest market opportunities ever for drugmakers, with a massive part of the population likely to eventually qualify for GLP-1 medications. In the U.S. alone, there are around 5 million patients already on some form of anti-obesity medication (mostly generics). But the total addressable market for obesity is much larger. Eli Lilly and Novo Nordisk are leading the charge, but the market is large enough for multiple companies to potentially benefit.

The longer-term medical benefits from GLP-1s also make us excited, given that obesity has been identified as an upstream

AI²—Two seismic developments with huge potential for change

Artificial intelligence and artificial incretins could shepherd in a new era

Artificial Intelligence (AI)



Artificial Incretins (GLP-1s)



AI²

Source: T. Rowe Price.

driver of more than 200 different types of diseases. Equally important, however, are the potential downstream effects in areas such as medical devices and consumer staples. Terminal values in both areas are coming under pressure as curtailing obesity is likely to have implications for future patient funnels for health care companies. Meanwhile, a reduction of caloric intake could also impact consumer companies, especially ones responsible for the manufacturing of processed foods, sweets, alcohol, etc.

At the same time, GLP-1s could also be one of the largest ESG innovations to arrive in the market in recent times, with fewer resources required to produce food if we are eating less.

The way forward

The current environment is challenging. Yet, we remain optimistic heading into 2024. The U.S. economy is not broken—people have jobs and consumers are spending, gasoline prices are flat year over year, and we expect earnings will be better than feared. There are still opportunities to find idiosyncratic alpha, and we are being open-minded about where those

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– Nabil Hanano
Associate Portfolio Manager

opportunities exist. However, we are not looking back to the old path. Instead, we are being mindful that evidence points to a different path. The makeup of the portfolio may change, but nothing will change in terms of our investment framework. We remain focused on buying quality companies, where we have insights about improving economic returns and we do not want to pay too much.

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