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Market Insights

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The Renaissance of Active Management

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2022 was a year of inflation. Most central banks were behind the curve and had to tighten aggressively to catch up. In 2023, I think focus will be more centered around the economic cycle. Inflation is slowly coming down. The question now becomes will we have a recession? Soft landing or hard? In a year, the narrative will be around the extent of the slowdown in economic growth and what the next economic cycle might look like.

What the yield curve may be signaling

The federal funds are now at about 4.5 to 4.75%, and the market is pricing in a terminal rate around 5.25% to 5.5%, signaling a couple more hikes.[1] The US Federal Reserve controls the short end of the curve. While three-month rates are a little higher, the market controls the ten-year rates, which are around 3.9%.[1] The curve is significantly inverted. Historically, when the yield curve inverts like this, the economy slows significantly or goes into recession. Yet, the markets are anticipating that the Fed will ease in the second half of the year. While inflation is set to come down in 2023, I think it will likely stay higher in the first half than central banks are comfortable with, and as a result, policy rates will likely stay higher for longer.

The case for active

Many recessionary signals are flashing, yet risk assets don't seem to agree. Looking at Wall Street consensus earnings, expectations, while down 2% to 5%, are not consistent with a typical recession, which would be down 10% to 30% plus.[2] In a traditional cycle, equity markets don't usually bottom until earnings bottom. Companies are suggesting that they can protect margins even though the economy will likely slow.

Yet, I don't think companies know what growth will look like, and looking forward, I don't believe that earnings have bottomed. This cycle will be different from the last, leading to an environment where active management matters. Decades of declining interest rates have acted as a tailwind for earnings and profits. Labor as a share of gross domestic product (GDP) came down and capital expenditures fell dramatically. These factors contributed to higher margins, which are still near all-time highs.

The backdrop of the last 10 to 12 years has reversed. As mentioned above, inflation will be higher, and central banks will not be able to bring rates down as expected. In response to lessons learned during COVID, companies are onshoring supply chains which will create additional costs. Following the global financial crisis, capital expenditure (capex) went to dividends, share buybacks and non-tangible assets.[3] Today, capital intensity has already gone up for many businesses as they invest in plants and equipment. Reducing carbon

intensity also means more capital being put to work. (The great thing about capex is that it potentially produces growth over time, and you can get a return on that.) Labor costs are rising as companies retain and hire employees. Investments in labor diversity and equality should lead to better growth and make the world a better place, yet that may come at the expense of margins. For those reasons, I think the cost environment for companies is going to be very different, and peak multiples and margins are in the rearview mirror, not ahead of us. Again, this is an environment where active management matters — identifying companies with strong competitive positions, pricing power and cash flows that can provide some protection for earnings.

Volatility and dispersion: Opportunity for active managers

We have come from an environment where central banks took rates to zero and suppressed volatility. Every time something bad happened, the Fed stepped in and provided liquidity. We're no longer in that environment; we're in one where volatility will be higher, which creates massive opportunity for dispersion and active managers. The era of cheap beta in passive management, I think, is behind us.[4] Differentiation matters and having an edge from a time horizon perspective makes a difference. Today, we are overloaded with information, but we're starved of knowledge. The ability to tune out the short-term noise and identify the things that drive long-term value is an advantage in the marketplace today.

The market is shifting once more toward valuing a business based on its cash flows. Looking back, a significant number of small-cap companies — zombie companies — didn't produce enough operating cash flow to pay their debt off. That capacity should have been removed from the system, allowing healthier companies to have pricing power. Those are the companies that should win. That's what active managers can do; try to identify and invest in them to seek risk-adjusted returns for clients.

Asset allocation: 60/40 is back

Over the past few years, people have wondered if the 60% equity/40% bond portfolio was dead? Looking forward, I think 60/40 is back. From an investment perspective, this environment is far better than the past decade. Cash has a return. Fixed income markets have an attractive return, even after adjusting for inflation. You can assess risk premiums on those rates now and build an asset allocation that makes sense over time. That wasn't the case when rates were near zero and volatility was low. Today, I think investment-grade corporate bonds make sense. You're getting an attractive yield with a reasonable spread for the credit risk, possibly providing a reasonable through cycle return. While equities and some of the riskier fixed income markets may have some challenges, a solid risk-free rate (Treasury rate) added to a 3% to 4% equity risk premium is a good through cycle return. We're not smart enough to call the bottom; if equities underperform for part of this year as earnings come down, I think rebalancing back to a 60/40 allocation or other proper allocation makes sense for investors. Opportunities are there for investors today, which was not the case a couple of years ago.

Endnotes:

[1] Bloomberg and US Federal Reserve as of January 14, 2023.

[2] FactSet Research based on constituents of the S&P 500.

[3] Capital expenditure or capex is the money an organization or corporate entity spends to buy, maintain or improve its fixed assets, such as buildings, equipment or land.

[4] Beta is a measure of the volatility of a portfolio relative to the overall market. A beta less than 1.0 indicates lower risk than the market; a beta greater than 1.0 indicates higher risk than the market. It is most reliable as a risk measure when the return fluctuations of the portfolio are highly correlated with the return fluctuations of the index chosen to represent the market.

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