2022 Global Equity Outlook: Disruption sharpens the focus on Future Quality

December 2021

By the Global Equity Team

The initial discovery of the Omicron variant was met with fairly sensational reporting by some of the world's media and this fed through quickly into investor sentiment (it is ironic that "media control" is an anagram of the words Delta and Omicron). This was even before the true nature of this variant of the virus is properly understood. Our hope is that it follows most other pathogens and becomes less virulent even as it becomes more adept at spreading. It is encouraging in this regard that the case fatality rate for the Delta variant was much lower than less transmissible earlier variants.

It is probably true, however, that even if Omicron had not surfaced it was probably about time that investors were again reminded of the volatility that resides in markets, despite the mollifying impact of endless liquidity injections by central banks.

The Federal Reserve (Fed) finally ditched the word transitory from their own characterisation of inflation but this does little to change the formidable challenge facing them. How does the Fed remove the liquidity injections to which investors have become so accustomed (fuelling rampant speculation in asset prices), without denting confidence too badly—with inevitable repercussions for real world economic activity?

China is ahead of the US in terms of normalising monetary policy, complemented by other central government initiatives. **If** they can eliminate the excesses evident in residential real estate without doing any more widespread damage, then the starting point for future economic growth should prove more sustainable, in our view. Our search for "Future Quality" companies in China is often frustrated by valuation. There are fewer quality growth Chinese companies (with proven track records of delivering high cash returns on investment). As a result, there is a scarcity premium attached to the companies that do. Hopefully a period of monetary tightening will remove some of this overvaluation.

Arguably it is easier, in our view, for a control economy like China to implement these changes, compared to countries where politicians are often motivated by prevailing popular public opinion. The problem is that the public may not always be great at thinking longer term. For instance, restricting the supply of overseas workers appeals to a cross-section of the population (and we are not saying that integration is without significant challenges). Will these restrictions really lead to greater opportunities for the local populations though? It certainly seems that there may be some short-term pain to reckon with—well before any long-term gain, in terms of broader employment opportunities for future generations.

The US Infrastructure Bill finally passed the US House of Representatives and has been seen as a huge win for anything construction related. Share prices have been very strong across the construction materials and building products sectors in anticipation. No one doubts the wisdom of spending more money on improving the crumbling US infrastructure, but it is probably fair to ask how quickly the concrete will get poured? Where will the construction workers come from that will be needed to turn these theoretical dollars into real economic activity? No one appears to care now, but they might…

According to the US Bureau of Labor Statistics, there are 1.5 million construction labourers in the US. These people are not sitting at home waiting for an opportunity to work at present (not many people are, if the US unemployment rate of just over 4% is to be believed).

By way of comparison, there are three million registered nurses (RNs) in the US. The availability of RNs has been a major issue for two of our Future Quality companies in recent months (LHC Group and Encompass Health). We do not believe, however, that these businesses are powerless in the face of the cost pressures facing them at present. Telehealth, increased use of (faster to train) nurse practitioners and greater use of automation will all help. This addresses an important component of Future Quality companies, their ability to adapt faster than peers to a changing environment.

The recent market volatility has forced some investors to address underperforming stocks, “If I didn’t own it already, would I buy it today?” is often a useful mantra. If the answer is “no” then it is likely only a fear of admitting you got it wrong or some other emotional attachment that is making you hold on. If the answer is “yes”, however, then we believe that one should be ready to take advantage of short-term factors to buy more.

We will not hide from the fact that this means tolerating underperforming shares from time to time—as long as we remain convinced about the long-term investment case. We won’t hide these investments from our clients either in favour of the more comfortable conversations that come if we only talk about outperformers. We continue to believe that we do not want all of our ships sailing in the same direction. That means foregoing some short-term return for smoother, better returns over longer time periods.

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