News

Opportunity in the Coming Cycle

Regardless of the cycle, active investors can benefit from idosyncratic earnings

- **Ben Leyland**

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21 Dec 2023

The long period of ultra-low interest rates came to a halt in March 2022 when the Federal Reserve lifted its target rate from 0—0.25% to 0.25—0.5%, its first increase in four years. Markets have since been in a transition phase, seeing heightened volatility as the excesses of the last cycle came home to bite. Investors are still grappling with the implications of the long, low-to-zero interest rate era coming to an end. The question now is where rates will settle and to what extent will investors still be rewarded for taking on duration, credit or equity risk.

Equity multiples tend to be inversely correlated with interest rates, so as rates have risen multiples have fallen. Additional risks include debt refinancing and cyclical earnings downgrades.

As rising interest rates put pressure on the macroeconomic environment, there's a certain cyclical element to earnings. But there are also wage pressures, cost pressures and the direct pressure of rising interest rates on the earnings power of businesses. At an index level, global equity valuations are still significantly higher than they were the last time bond yields were around current levels.

Opportunities on the horizon

Despite the current pressures, we believe active managers can thrive in this phase and the opportunities for patient, selective equity managers are growing. The chart shows the global index remains distorted towards the winners of the last cycle, particularly a handful of names in the US tech sector, which enjoyed an AI-driven 'echo boom' in the first half of 2023. Digitalisation still represents a significant weight in the MSCI ACWI, and valuations in this part of the market look stretched to us.

Notes: [1]Utilities, Industrials, Energy, Materials; 2Information Technology, Communications Services; Consumer Discretionary. Data as at 30 September 2023. *Big 7: Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Tesla. Data as at 31 May 2023.

But there's a growing cohort of attractively valued and underappreciated companies. These businesses either have more idiosyncratic drivers, or they have exposure to a renewed cycle of capital investment and infrastructure renewal, which we expect to be a feature of the coming decade.

There's no doubt the disruptions of the last few years have highlighted certain vulnerabilities. The consequences of long periods of underinvestment are now starting to be addressed, particularly in energy security and supply chain resilience. These beneficiaries could be found in 'real world' sectors like industrials, infrastructure and materials, which will likely see their quality and growth characteristics steadily reevaluated over the medium term. In regional terms, favour will find any non-US equity markets which have a different sectoral mix to the tech-heavy US market.

There is one caveat to bear in mind. Due to the inherent cyclicality of these sectors and the heightened macroeconomic and geopolitical risks, it's important to be selective with stock picking and avoid names with fixed costs or financial gearing. The best stocks are those which are reasonably macroeconomic insensitive, meaning their earnings will be resilient if a recession does land. There will be a time to buy cyclicality for its own sake, but it isn't now.

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