Strategic Global Advisors®

# Reflection & Inflection

January 2022

## Introduction

The New Year is a time to reset, examine the past and, more importantly, to assess the future with a clear mind and a blank sheet of paper. We would also like to take this time to pause and thank our clients and those who work with us for your confidence and faith in what can only be regarded as a wild ride – in both the markets and many of our personal lives.

In this regard, we use this note to look beyond SGA's own investment strategies and set a broader stage for thinking about the best way forward in 2022 and beyond – because the tea leaves indicate we may be very close to an important inflection point in the economic backdrop.

It is our view that what's worked for the past 10-years, 20-years, and 40-years, may not work quite the same way going forward. We discuss how an impending economic change may impact various asset classes and believe there is a strong longer-term case to be made for Equities over Bonds; Public over Private Equity; Non-U.S. over U.S. equity and a Core approach over either Value or Growth.

**SNAPSHOPT**

### Are we at an inflection point in the economic backdrop?

**IN THIS PAPER**

- Equities over bonds
- Public equity over private equity
- A core approach rather than Growth or Value alone
- Non-U.S. markets over U.S.

**AND…**

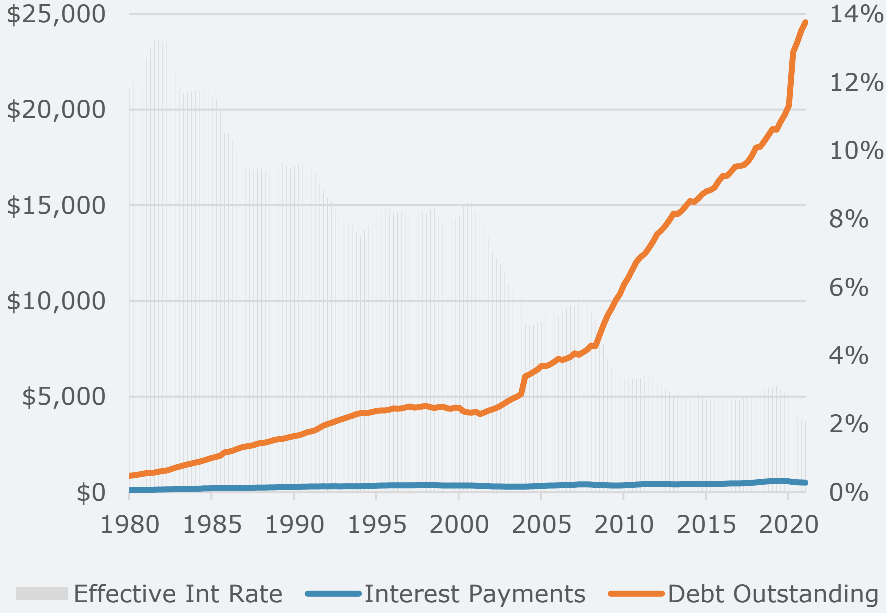
We wish all of our clients, friends, and your families the best of wishes for a healthy and prosperous 2022!

# Is it the end of the happy dynamic?

Unless you are truly an elder statesman in the industry, your entire investment career has played out within the shadow of a massive, 40-year disinflationary and balance sheet leveraging environment.

Here we show this backdrop through the lens of the U.S. Federal Government. You can see in Figure 1 how interest expense has fallen (the grey bars); how debt levels have increased by a factor of 28x (orange bar), with step-ups right after the Global Financial Crisis ("GFC") and last year's COVID-19 response, but, and this is the "Happy Dynamic," the total dollar cost of servicing the bigger debt pile (the blue line) has barely budged (up 5x, or a CAGR of 4.3%).

**Figure 1: U.S. Federal Borrowing & Debt Service**




*Source: St. Louis Federal Reserve Bank*

This same dynamic played out on the corporate side - rising debt levels accompanied by minimal debt service costs – which has had positive implications for things like dividends, stock buybacks, private equity activity, and the performance of lower quality companies. We will explore each of these later in this note.

Importantly, this backdrop is not what we will likely see going forward. The grey bars (interest expense) are unlikely to continue falling, and most likely will climb, and the blue line (the cost of servicing the debt) is expected to climb rapidly, which itself will push up debt levels even further – all having implications for asset price performance.

The end of the Happy Dynamic and a reversal in interest rate trends are most likely to be triggered by rising inflation and a pull-back in Central Bank security purchases (i.e., tapering). We all know that prices are already up. From gas at the pumps, to used car prices, rents, housing, food, lumber – higher prices are here.

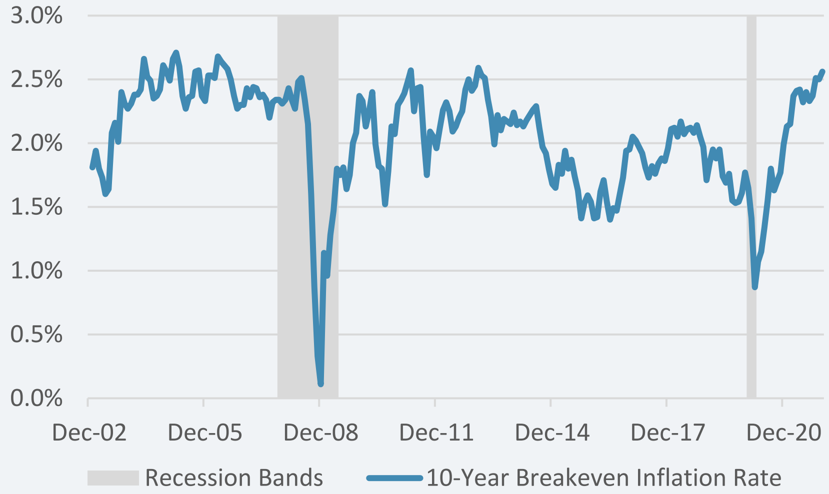

However, the Central Bankers told us, not to worry, it's all transitory. In fact, the word "transitory" was mentioned a record number of times for any calendar year in U.S. earnings calls in 2021 and a record number of times for any month in November according to information from the data firm Sentieo.

And while "transitory" was on everyone's mind just a few short weeks ago, with the turn of the calendar, "transitory" is out and "inflation" is in. Bank of America analysts note the use of the word "inflation" in S&P 500 company earnings calls has sky rocketed by 1100% to a new record.

## Is inflation transitory?

So far, the market still clings to the transitory narrative. Figure 2 shows the historical market derived expectation for inflation, otherwise known as the "breakeven" inflation rate. All said, over the last 20 years this expectation has fluctuated between 1.5% and 2.5% other than during the recessionary periods highlighted in grey – though more recently it has moved to the upper end of that range. Those believing in the transitory case expect we will see more of the same with the blue line remaining in its narrow two-decade long channel of 1.5% to 2.5%.

**Figure 2: 10-Year Breakeven Inflation Rate**




*Source: St. Louis Federal Reserve Bank*

So, the question for everyone reading this note is: *If markets believe inflation is indeed transitory, and this is what is priced into assets today, what happens if markets are wrong, inflation is not transitory, and expected inflation breaks out of this narrow range?*

And the obvious follow-on question: *Are you ready if this is indeed the INFLECTION point?*

## A deeper look at where we've been

Let's begin by looking at why rising rates might be an issue? In Figure 3 below we show the fiscal state across the G7 countries, and it does not look good. For the most part, total debt is larger than GDP, as you can see in the first row. The relationship between the two is important as GDP is the foundation on which new growth is based. This new growth can either be re-invested to set the stage for future growth or used to pay debt service costs (previous borrowing). With the two at parity, economic growth must remain above debt service costs lest we face the danger of a spiraling period of economic contraction.

**Figure 3: G-7 Countries Federal Government Fiscal Picture**

| | USA | CAN | JP | UK | GER | FR | IT |
|---|---|---|---|---|---|---|---|
| **Gross* Debt / GDP** | 162% | 141% | 257% | 149% | 79% | 146% | 184% |
| **Eff Int Rate**** | 1.26% | 1.41% | 0.54% | 1.89% | 2.04% | 2.08% | 2.21% |
| **% Mature < 3-yrs** | 52% | 54% | 51% | 16% | 32% | 36% | 50% |
| **% Mature > 10-yrs** | 16% | 19% | 23% | 58% | 26% | 33% | 15% |

*Data as of 12/31/2020; Source: OECD, Bloomberg, SGA Calculations*
**Gross Debt = Net Debt + Financial Assets (Gross Debt better at outlining debt service risk, Net Debt better at outlining credit risk)*
***Effective Interest Rate is a function of maturity distribution and interest rate levels*

# A deeper look at where we've been (cont'd)

The Effective Interest paid, the second row, which we looked at previously for the U.S. in Figure 1, is low across nearly every developed country. This is both a function of overall rates and where along the curve governments have chosen to finance themselves, whether short or long as short-term rates are typically lower than those further out on the maturity curve.

The third and fourth rows have the most important data points on the page as they show how countries have chosen to finance their debt, whether long or short: the amount due in less than three years and the amount that won't mature until beyond 10-years. The key is that those countries with shorter maturities are most exposed to rising debt service costs in the event of higher inflation, with those at highest risk including the U.S., Canada, Japan, and Italy who all have more than 50% of their debt coming due within the next three years. The U.K. is at the opposite end of the spectrum with only 16% of its debt coming due, with Germany and France closer to 30%.

Again, if rising prices are not transitory, rising debt service costs are certain to have an impact on economic growth while increasing budgetary pressures to raise taxes in a potentially inflationary environment.

# Who benefitted?

So now that we've looked at the macro backdrop that has prevailed for over four decades, let's try to understand a bit about what could happen should it reverse – and let's also take a minute to understand who the big beneficiaries of the past disinflationary cycle were, and how it affected investor behavior.

Falling rates, of course, benefited bonds through capital gains, but did cause investors, particularly institutions with fixed actuarial return targets, to chase yields down the credit spectrum to sustain returns as overall rates continued to fall (moving first from Treasuries to Investment Grade bonds to High Yield bonds to Private Credit).

**Figure 4: BBB U.S. Corporate Option Adjusted Spread**

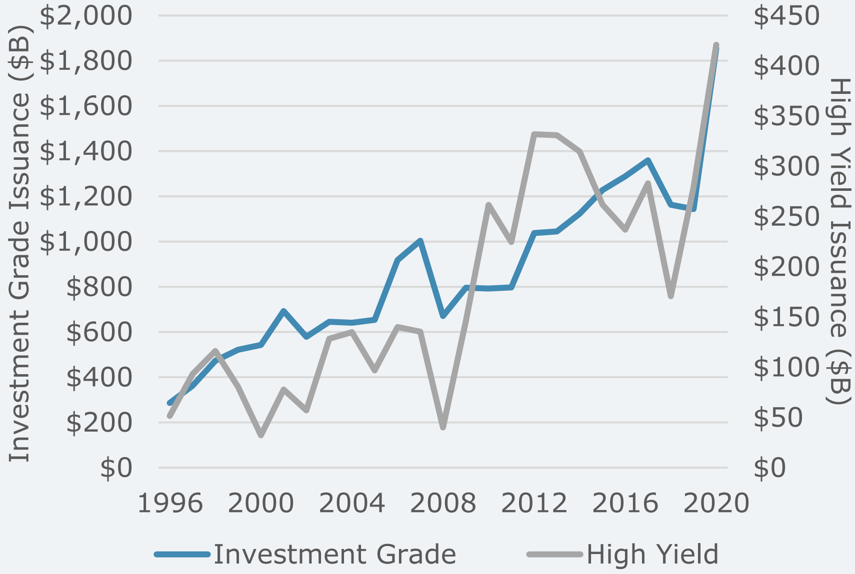

*Source: ICE Data Indices*

Figure 4 above shows how investment grade bond spreads are currently close to historic lows and have been trending downward since the end of the GFC as investors chased yield.

## Increased issuance

The chasing of yield was met with record bond issuance (Figure 5) and less stringent covenants along with the maturation of the Direct Lending / Private Credit asset class, now nearly $1 Trillion in size according to Preqin.

**Figure 5: U.S. Corporate Bond Issuance ($B)**



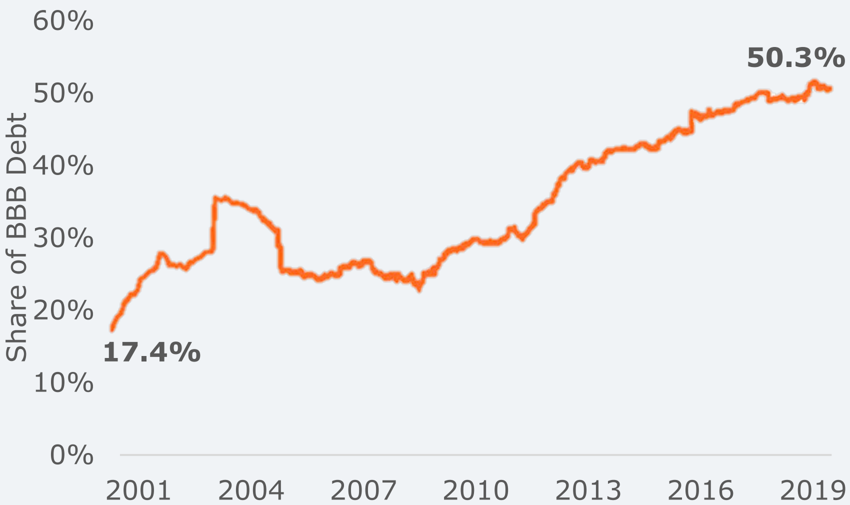

*Source: SIFMA*

## Lower quality

The orange line in Figure 6 shows how much of the increased issuance was concentrated at the lower end of the investment grade scale (securities rated BBB).

In 2001 BBB's were just 17% of the total while today more than 50% of corporate debt is BBB-rated and the bulk of that deterioration coming since the Global Financial Crisis.

**Figure 6: BBB-rated Debt as a Percentage of Overall Corporate Debt**




*Source: Barclays, BlackRock, Bloomberg*

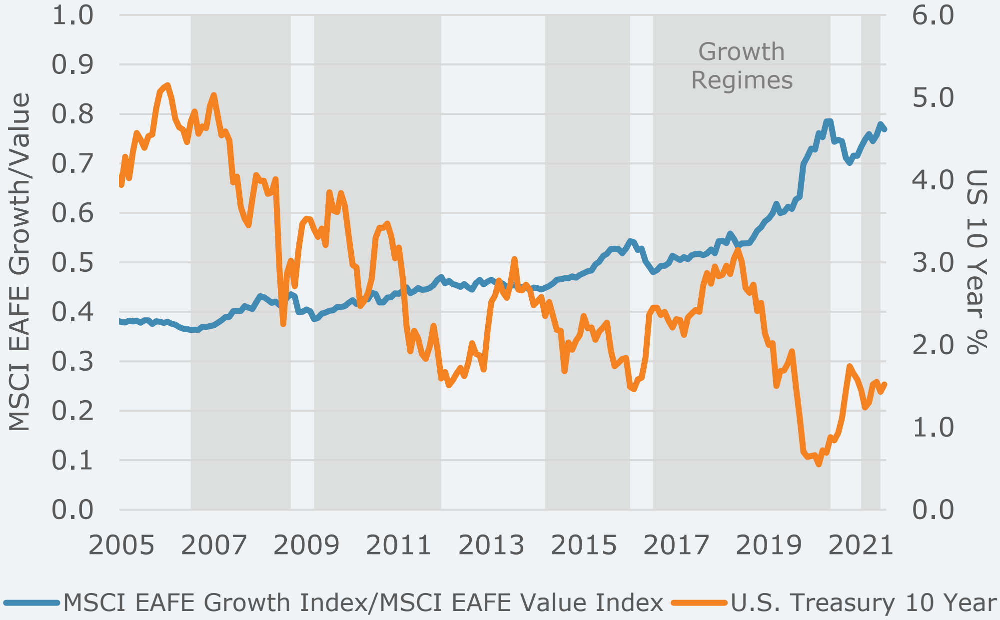
Falling rates also supported many corners of the equity world. Lower quality companies had fewer problems finding credit at an attractive rate. **As discussed in the following section and charts, Growth stocks experienced one of their longest and strongest periods of outperformance versus Value stocks as low rates raised the present value of earnings far in the future. At the same time Private Equity had, what might be referred to as its Golden Age.**

As to covenants, Moody's Investors Service now compiles and reports a "covenant quality indicator" that further tells the story of credit risk. That gauge rates certain investor protections on a scale of 1 to 5, with 5 representing the most flagrant disregard of covenants. Overall, North American bonds scored a 4.58 in Q3 – their worst reading ever. Just to give you an idea of how that compares, EM debt is scored at 3.53 (and has shown some signs of improvement of late).

## Style investing

And then there are equities.

Figure 7: MSCI EAFE Growth/Value and U.S. Treasury 10 Year Yield




*Source: MSCI, FactSet*

Equities of most stripes enjoyed strong returns over the past four decades, interrupted by periodic, but short-lived, periods of decline (the 1987 October crash, the bursting of the Tech Bubble, and the Global Financial Crisis being the most notable). Growth stocks, and growth style mandates, in particular, did exceedingly well as rates fell. You can see that in Figure 7 from the blue line which is the ratio of the EAFE Growth/EAFE Value indices. The grey bars denote periods where growth did notably better than value and you'll see these periods usually coincided with falling rates (the orange line). In fact, since the GFC, as rates fell, growth stocks nearly doubled the performance of value stocks with half of the outperformance coming during just the three years 2018 – 2020 (what we later refer to as the "piling on" years).

The why, however, may not be quickly apparent. If you think about the value of a stock as the present value of its future cash flows, falling rates mean less of a discount applied to earnings farther in the future, and Growth stocks valuations rely more on these future earnings than this year or next year's number.

Now, with rates no longer falling and potentially going higher, those future earnings will shrink in terms of their present value. It doesn't mean we advocate entirely abandoning growth stocks, just that valuation multiples will fall. Simply put: the falling rate tailwind becomes a rising rate headwind and valuation multiples will battle underlying earnings growth.

Valuation and Growth shouldn't be looked at in isolation

Similarly, it doesn't mean we advocate going all-in on deep value stocks. Many will be value traps as low valuations alone don't mean cheap, and while growth outperformed, it didn't mean value declined. Many value stocks are also richly priced today. We believe the road forward means incorporating expectations of growth and rising rates into your valuation metrics. In other words: Valuation and Growth shouldn't be looked at in isolation. This wasn't the case over the past few years when growth at nearly any price was your best bet. However, with the potential for rising interest rates increased, we see growth and value on a more equal playing field and believe a Core approach may be more appropriate for investors.

# Growth vs Value

And let's add one more take on the performance of Growth relative to Value.

Figure 8 details the percentage of style mandates (non-U.S. equity) allocated to Growth and shows how investors piled into such mandates at the expense of their Value counterpart, particularly from 2018 forward with Growth mandates surging from 45% of style allocations to nearly 60%.

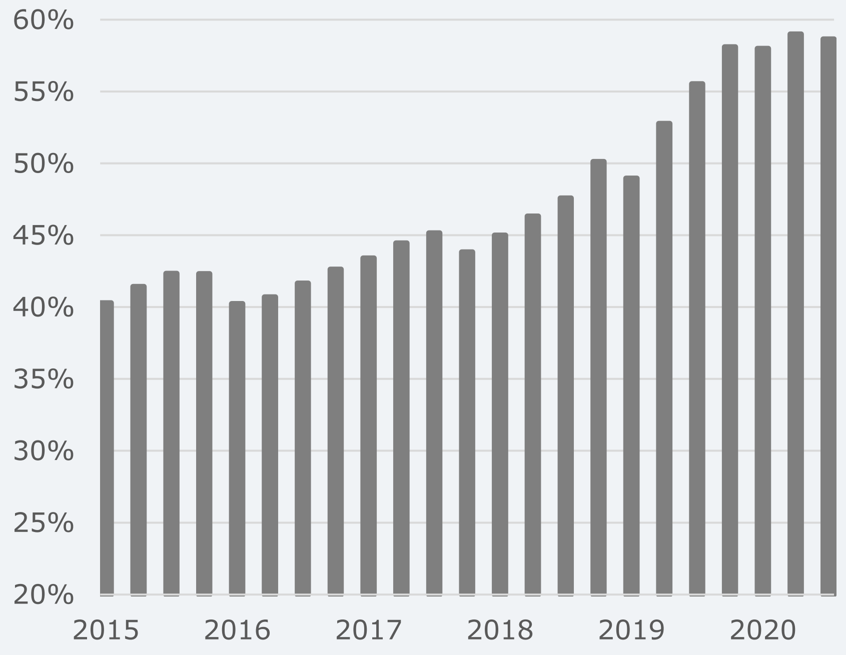
It seems, the long outperformance of the Growth style itself, attracted more investors to the asset class, perpetuating (and magnifying) its strong performance. Now, after a decade of outperformance, and the last three years of piling on, this has likely become a crowded trade.

# Private equity / public equity linkage

We would also like to briefly address the Private Markets as a couple of observations do bear mentioning and there is an inescapable linkage between private and public equity markets.

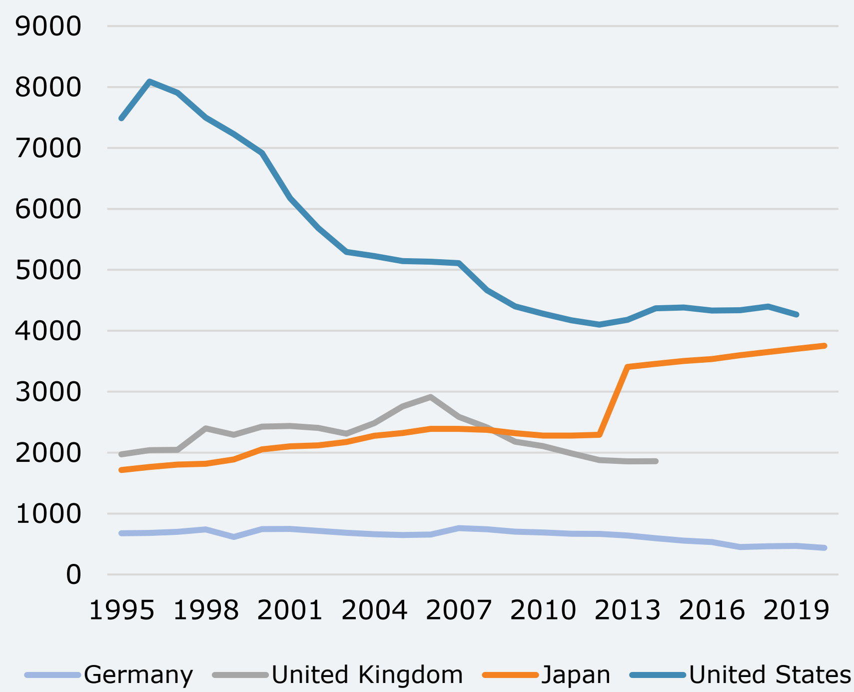
First, note how the number of publicly listed companies has declined in the developed markets. In the U.S. we have seen a shrinkage from 8000 to just over 4000 in the past 20-years. Though the trend is not as extended or having gone on as long overseas, we also see a decrease in both Germany and the U.K. since the GFC. Japan is a bit of an outlier as a merger of stock exchanges in 2013 led to a bump in the number of listed companies.

**Figure 8: Non-U.S. Growth Equity Mandates % of Total Non-U.S. Equity Style Mandates**




*Source: eVestment*

**Figure 9: Number of Listed Companies**

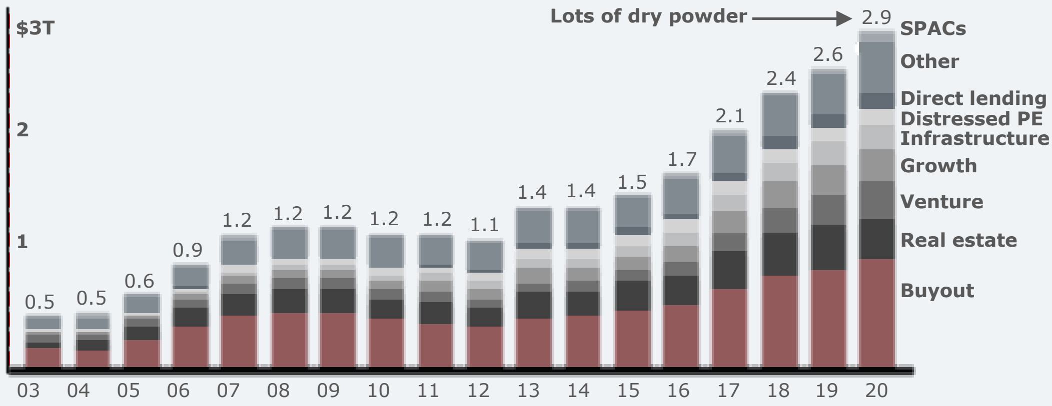



*Source: World Bank*

Secondly, Figure 10 shows a record amount of unspent capital, now over $3 trillion dollars, sitting at private equity shops, meaning these trends are likely to persist.

The results of past private market activity have been a shrinking pool of public companies and just as importantly, higher deal multiples, particularly in the U.S. Valuations in Europe, outside of a dip during the midst of the GFC, have held steady as seen in Figure 11 below. The point is that with lots of dry powder, more attractive valuations abroad, and the explicit opening of offices by many of the larger PE players in Europe and Asia, we expect PE support going forward to favor non-U.S. public markets.

## Figure 10: Global Private Uncalled Capital, by Fund Type

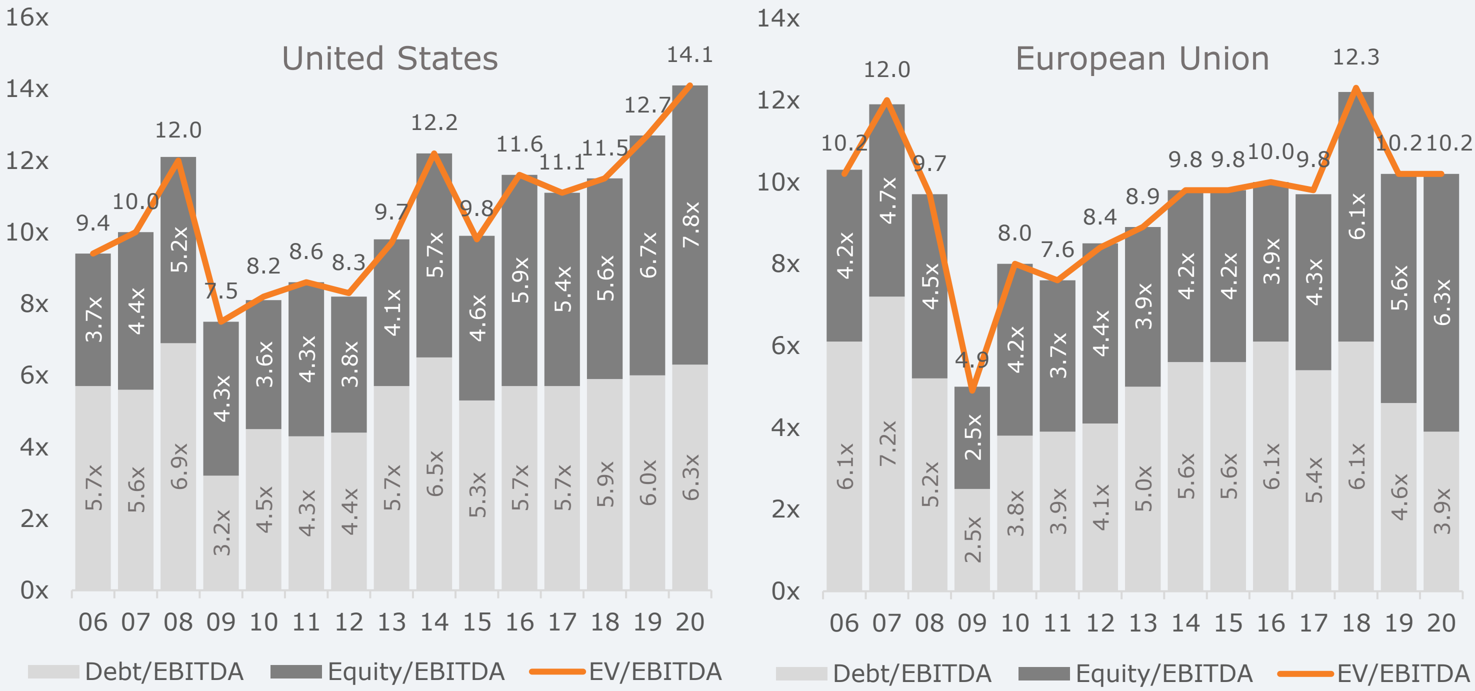



| | 03 | 04 | 05 | 06 | 07 | 08 | 09 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Buyouts ($B) | 199 | 188 | 275 | 398 | 479 | 515 | 512 | 453 | 417 | 386 | 460 | 476 | 527 | 568 | 724 | 829 | 891 | 970 |
| Buyouts and buyout SPACs ($B) | 199 | 188 | 276 | 400 | 485 | 517 | 512 | 453 | 417 | 386 | 461 | 477 | 529 | 570 | 729 | 834 | 898 | 1012 |

*Notes: Other includes fund-of-funds, secondaries, natural resources and mezzanine; buyout includes buyout, balanced, coinvestment and coinvestment multimanager funds; SPACs fund-raising used as best proxy for SPACs dry powder; buyout SPACs estimated as approximately 50% of total SPACs directed to buyout deals; discrepancies in bar heights displaying same value are due to rounding.*

*Source: Bain & Company, Global Private Equity Report 2021*

## Figure 11: Private Equity Deal Multiples and Leverage




*Source: PE Compass, data from Pitchbook Q4 2020*

# Domestic vs international

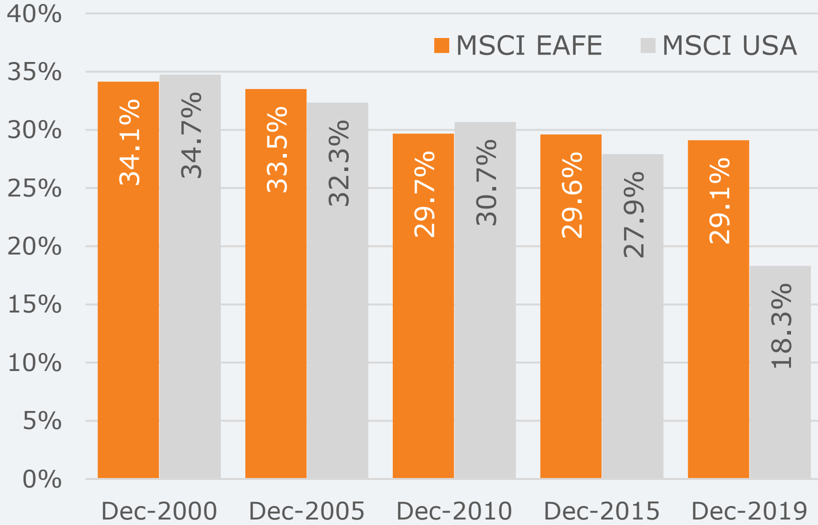
Finally, let's look at U.S. versus non-U.S. markets and see where investors might find opportunity. And to remind you of the earlier 'G-7 Countries Federal Gov't Fiscal Picture' Figure 3 which showed how much better European markets are positioned relative to those in North America with respect to rising interest rates.

We are all aware that foreign markets offer important diversification benefits, but this is particularly so in a rising rate environment as relatively little European debt is coming due in the next three years, as reflected in Figure 3. This means the pressure on those governments to raise future taxes, which can have a dampening effect on growth and markets, is less likely to have a bite overseas than at home.

Tax rates, in fact, explain much of the advantage U.S. companies have enjoyed over their non-U.S. peers, particularly over the past five years. The following Figure 12 is reproduced from a 2020 SGA note. In this chart, the grey bars show the aggregate tax rate on companies in the MSCI USA benchmark while the orange bars show the same metric for non-U.S. companies as expressed in the EAFE benchmark. As U.S. tax rates fell from roughly 28% to 18% in the past 5 years, and international rates held relatively steady, U.S. stocks picked up a 3.3 percentage point relative ANNUAL growth boost in EPS. With higher rates and rising deficits along with a change in political leadership in the U.S., a continuation of this trend is highly unlikely. Indeed, a reversal is more likely.

We are optimistic on the outlook for non-U.S. companies going forward given a more defensive posture in the event of rising rates resulting in a more stable tax rate environment.

**Figure 12: Effective Tax Rate (%)**
**MSCI EAFE & MSCI USA**




*Source: SGA, MSCI, FactSet*

# Summary

In the Fixed Income world, it's going to be tough to make money with yields at (in many cases) century lows. Further, chasing yields by extending down the credit spectrum is less likely to provide as much boost as in the past with spreads now tighter and poor covenant protections raising risk levels.

On the equity side the lower rates and abundant liquidity which helped support lesser quality companies, especially since the 2018 step up in Central Bank bond buying, should become less favorable. If rates bump higher, quality will become a more important differentiator of stocks performance and the extremes of growth at any price are likely to stumble.

# So where does this leave us?

- We prefer equities over bonds.
- We prefer public equity over private equity.
- We recommend a Core approach, encompassing Quality, Valuation, and Growth factors better than Growth or Value alone.
- And finally, we prefer non-U.S. markets, relative to the U.S. In addition to their valuation advantage, there is the tax backdrop. We expect greater private equity support and perhaps a less negative macro rate environment.

## Important Disclosures

This paper is meant for illustrative purposes only and is not intended as a recommendation to invest in any particular asset class or strategy. The views and opinions expressed in this paper are those of Strategic Global Advisors, LLC and should not be construed as an estimate or a promise of results that a portfolio may achieve. The materials provided in this presentation and any comments or information provided by the authors are for educational purposes only and nothing presented should be considered legal or investment advice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

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For additional information, please contact Strategic Global Advisors, LLC.

## Contact


Tel: (949) 706-2640
www.sgadvisors.com

100 Bayview Circle Suite 650
Newport Beach, CA 92660


### Brett Gallagher
President

Mr. Gallagher is President of SGA. Prior to joining the firm, he was a partner and served as Director of Research and Acquisition at Nile Capital Group, a Los Angeles-based private equity firm. Previously, he served as Deputy CIO at Artio Global Investors/Julius Baer Investment Management, Head of Investment Management Asia for JP Morgan Private Bank in Singapore, and Head of Global Equity for Bankers Trust International Private Bank. Mr. Gallagher has appeared numerous times on CNBC, Bloomberg, and Fox Business News as well as having been quoted in The Wall Street Journal. He was also a guest lecturer at Yale University. Mr. Gallagher received his BA in Economics from the University of Virginia and his MBA from The Darden Graduate School of Business. He is currently a member of the Board of Managers and member of the Investment Committee for the University of Virginia Alumni Association.