The End of the Beginning

February 2023

Over the course of our careers, we have seen that significant long-term change is often obscured and even accelerated by short-term disruptions. This is true for companies as well as for the broader investment landscape. The Covid pandemic, Ukraine war, and events in China are obfuscating and reinforcing trends that will mark the investment landscape for the next decade. Incidents like these naturally distract investors and shorten their time horizons as they struggle to deal with the immediate impact on markets. Often, significant changes only come into full focus years later.

Investors cannot afford to wait to see the bigger picture. Our process of selecting and holding Sustainable Growth businesses for clients over 3 to 5 years requires us to peer through the turbulence and focus on the impending environment beyond current events. We are not macroeconomists but have over a hundred years of collective experience around our table, which we continually enhance from insight gained in our regular contact with some of the best business management teams around the world. We believe the Covid pandemic and recovery, Ukraine war, and developments in China portend a significant shift in the investment environment leading to slower secular economic growth due to:

- A higher level of inflation and interest rates as perennial policy accommodation comes to an end,
- A lower level of productivity growth as globalization backtracks, and
- A higher level of geopolitical risk in an adversarial multi-power world.

While these developments have been widely reported, only the effects of higher interest rates seem to have been discounted in markets as investors witnessed the dramatic pivot of central banks reacting to inflationary forces that proved to be more than "transitory". The real question is prevailing rates beyond the tightening cycle, and the implications for long-term growth. We believe we are just at the end of the beginning in the transition to the next investment regime and investors' recognition of those forces on companies and markets.

Much has been written about the risk of stubborn inflation and higher rates. We began worrying about higher rates and the impact on valuation in late 2020 when our DCF discount rates moved into the mid-single-digits with collapsing sovereign rates. We padded our assumptions at the time recognizing the very low-rate environment was unsustainable. With the benefit of hindsight, it was not enough. At this point, our valuation work suggests that the damage of higher rates to our portfolios has largely been done. We are now discounting cash flows at about 10%, appropriate for our view of mid-single-digit long rates, and consistent with our goal of delivering a double-digit return. Our portfolios of Sustainable Growth enterprises have a projected cash yield at a historically attractive level of 3.5%[1].

Now many are debating the timing and depth of recession, but the likely decay of secular growth in the world receives less press as the short-term impacts of recent events subside. It is very difficult to parse out the non-recurring component of recent disruptions from the underlying trends. Admittedly, we have had difficulty separating some of these short-term forces on business from the longer trends, for instance attributing much of PayPal's rapid user growth during the pandemic to secular rather than transient forces. The Covid pull-forward of demand masked a greater maturation of Amazon and Salesforce than we expected, compelling us to revise projections lower. More broadly, we believe investors are wrestling with the "noise" of current events and are slow to recognize the lurking impact of longer-term forces on global growth.

Supply chain weaknesses revealed by the pandemic and growing geopolitical divisions have set in motion an inevitable reversal of globalization which has been a major driver of productivity and growth. There are several factors at work here. In 2021, we started to discern this reversal in the dramatic change in the Chinese Communist Party priorities emphasizing "common prosperity" over growth, and perhaps setting the country on a collision course with the West. The Russian invasion of Ukraine last year further cemented our view of the reversal of globalization and new challenges to growth globally. At the end of February, we began lowering earnings estimates for our companies and adjusting portfolios accordingly. These geopolitical tensions will likely be with us for some time and while we cannot predict the outcomes, we must understand and navigate their impact on growth.

We have seen in our fundamental company research and in conversations with business leaders that decades of progress building out global operations and fine-tuning supply chains with the use of technology have left them vulnerable to these recent interruptions. Global operations must now be reevaluated and supply chains pulled back to be protected from core disruptions. The reversal of globalization will likely magnify the impact of adverse demographics and keep labor markets tight

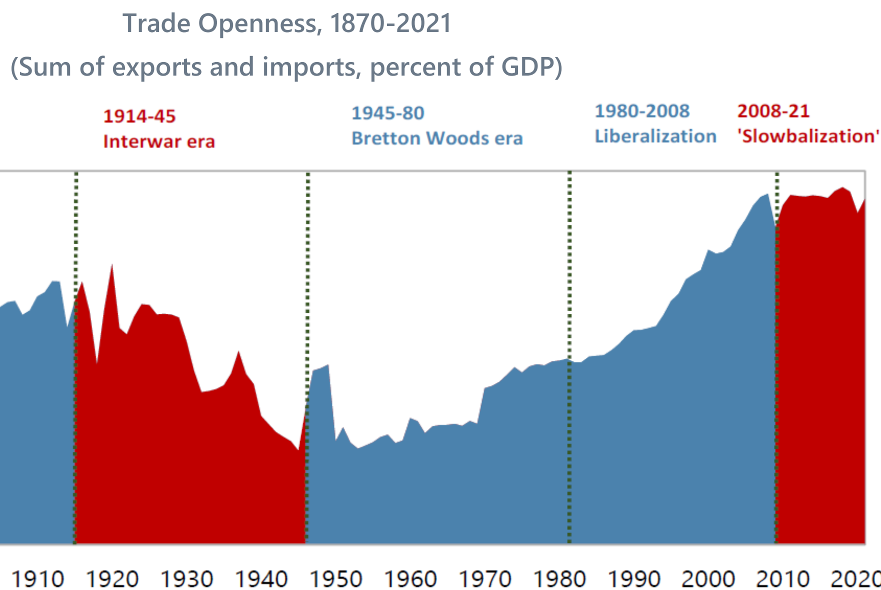
[1] *For the SGA Global Growth Portfolio as of 12/31/22.*

as supply chains are pulled closer to the source of demand creating local mismatches. Recent disruptions of energy supply due to war in Europe are likely permanent, and the creation of alternative sources will take years. The need to reduce reliance on Russian and OPEC fossil fuels and the adverse demographic trends were visible before, but recent developments have accelerated their impact.

Developments in China may also be obscuring an inevitable long-term trend. Hidden in the backdrop of Covid disruption is significant maturation of the world's second largest economy, especially as Western businesses seek to "re-shore". The reprioritization of "common prosperity" at the expense of economic growth, the collapse of a real estate bubble, and adverse demographics should logically lead to muted growth. While a growth rebound this year from withdrawal of the zero-Covid policy is expected and GDP per capita will continue to advance, China is no longer the growth engine of the world and the major disinflationary force it has been in the past.

All these forces are coalescing in a trend that is likely to lead to a reversal of decades of improvement in efficiencies and disinflation. We believe the implications for global growth are clear. Most economies will struggle to generate even low-single-digit real growth with lower population growth and fewer productivity tailwinds. Central banks and populist governments have come to the rescue to buffer this inevitable slowing in the past, but inflationary pressures and a reversal of globalization's disinflationary forces will limit policy responses. With higher rates, debt will "matter" to people, companies, and countries again.

As we peer through the haze created by the turbulence of current events, we see secular trends that will define the next investment regime, in a period marked by the persistent pressure of inflation, lower growth, and rising geopolitical risk. While the market has efficiently discounted higher rates, it does not seem to be looking past the current turbulence to the long-term implications. The revisions to GDP forecasts that are coming may be dramatic as globalization tailwinds increasingly turn to headwinds and we move from an era of globalization to a period of "slobalization". The IMF just estimated that "geoeconomics fragmentation" could cost 7 to 12% of GDP.[1]



Source: Jorda-Schularick-Taylor Macrohistory Database; Penn World Data (10.0); Peterson Institute for International Economics; World Bank; and IMF staff calculations
Note: Sample Composition changes over time

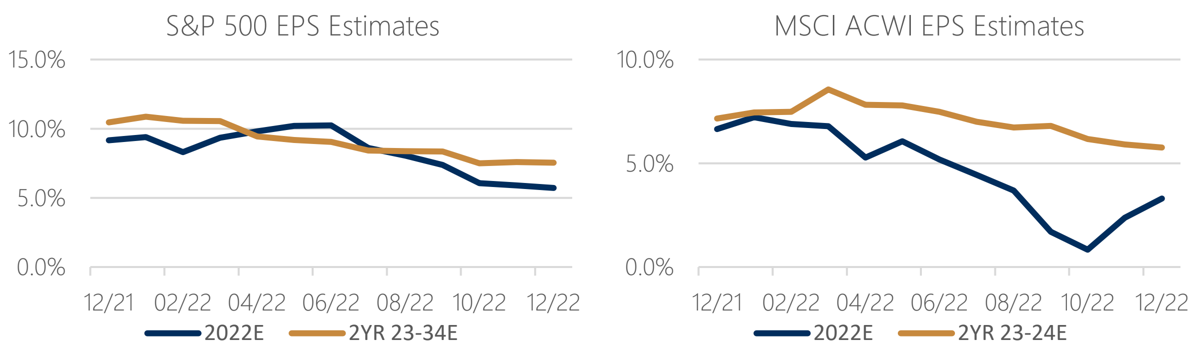
We have been revising our own company estimates not only for a recession, but a more muted secular growth environment and have adjusted our portfolios accordingly. We sold positions in Meta Platforms and Walt Disney, where we perceived higher economic exposure and reduced pricing power. We eliminated positions in PayPal and Illumina, where future growth has become less predictable. We took advantage of valuation compression to replace these holdings with companies that have demonstrated more pricing power, such as Ecolab, Adobe, and S&P Global, as well as businesses that are resistant to economic slowdown, like IQVIA, Aon, Steris, and Dollar General. And, we have factored into our decision-making the implications of the intensifying geopolitical risk, limiting portfolio exposure to China-based businesses to those that are clearly

[1]*Aiyar, Shekhar, Ilyina, Anna, and others (2023). Geoeconomic Fragmentation and the Future of Multilateralism. Staff Discussion Note SDN/2023/001. International Monetary Fund, Washington, DC.*

aligned with new government priorities like AIA Group and Mengniu Dairy, and participating in Chinese GDP per capita growth with non-Chinese businesses like Starbucks and CP All.

Because our process starts with Sustainable Growth companies that have recurring revenues and pricing power, our revisions and adjustments have been more muted. Our portfolios should continue to deliver reliable double-digit earnings and cash flow growth over the next 3-5 years, as they have in the past. This is why we often refer to our holdings as "growth bonds". Overall corporate earnings are likely to experience slowing growth over the next few years, making them less competitive relative to bonds, a portfolio alternative once again. Although the consensus estimates for growth of the major indices have come down for this year, they still anticipate a resumption of higher growth. It has been a difficult and humbling time, especially since our primary focus is delivering absolute returns for clients. But now that higher rates have been largely discounted in valuations, we believe we are at the end of the beginning and our Sustainable Growth portfolios and their reliable double-digit compounding earnings are an attractive option in what we believe will be a growth-starved world.

Index Earnings Expectations Remain Elevated



Source: FactSet, S&P, MSCI

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