RIVERFRONT INVESTMENT GROUP

Strategic View

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SUMMARY

- The US is finally exiting the era of negative real interest rates.
- We think positive real rates tend to accompany a 'reflationary' backdrop of moderately elevated economic growth and inflation.
- We believe US energy stocks are uniquely well-positioned in a 'reflationary' backdrop.

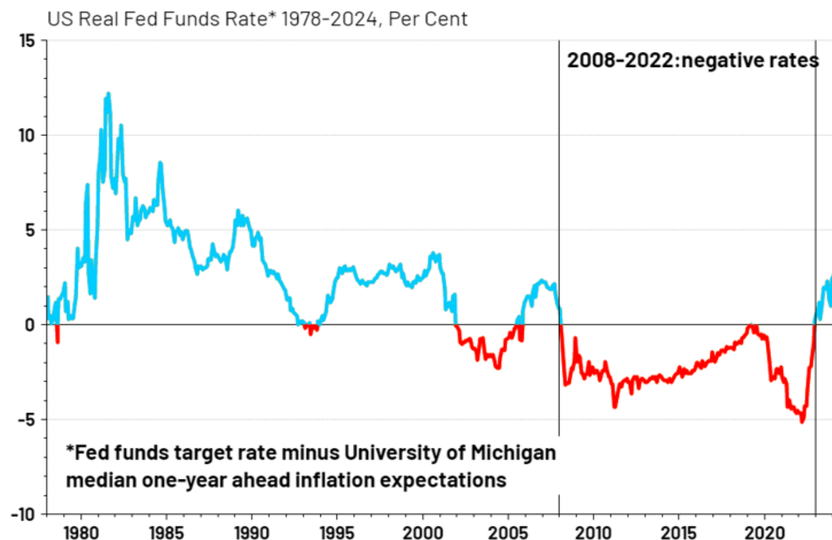
05.07.2024

Positive 'Real' Interest Rates are a Game Changer! (Part Two)

Energy Benefits From Higher Growth and Inflation

(Today is the second part of a multi-part Strategic View series entitled 'Gamechangers,' in which we explore the various investment implications of a return to positive real interest rates in the US.)

Congratulations! if you have been alive longer than 15 years, you just lived through the entirety of one of the weirdest, most subtly unsettling eras in market history...and we are not referring to COVID-19, Brexit or even the Great Financial Crisis (GFC) per se. Rather, we are talking about the bizarre decade-and-a half-long period where US interest rates consistently yielded below zero after adjusting for expected inflation.



Source: LSEG Datastream, RiverFront: data monthly as of April 15, 2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

In the US from 2008 to 2022, the Federal Reserve's fed funds 'real' target interest rate – 'real' meaning adjusted for consumer inflation expectations over the next year – was consistently negative (see red region of Chart 1). This unusual era of 'Financial Repression' was in our view a by-product of a Fed determined to jumpstart the abnormally low economic growth caused by a series of rolling global economic crises – the GFC, various European crises, and COVID-19 among them. These crises, in our view, were exacerbated by aging demographics in the developed world leading to excess saving and reduced risk appetite... as well as slowing growth in China and various other factors.

Financial Repression – Not A Victimless Crime

The 2008-2022 Fed had its reasons for such extreme measures, in trying to stimulate risk-taking and economic growth in an era where there was often little of either. And by some measures, they succeeded. Over this 15-year span, US large-cap

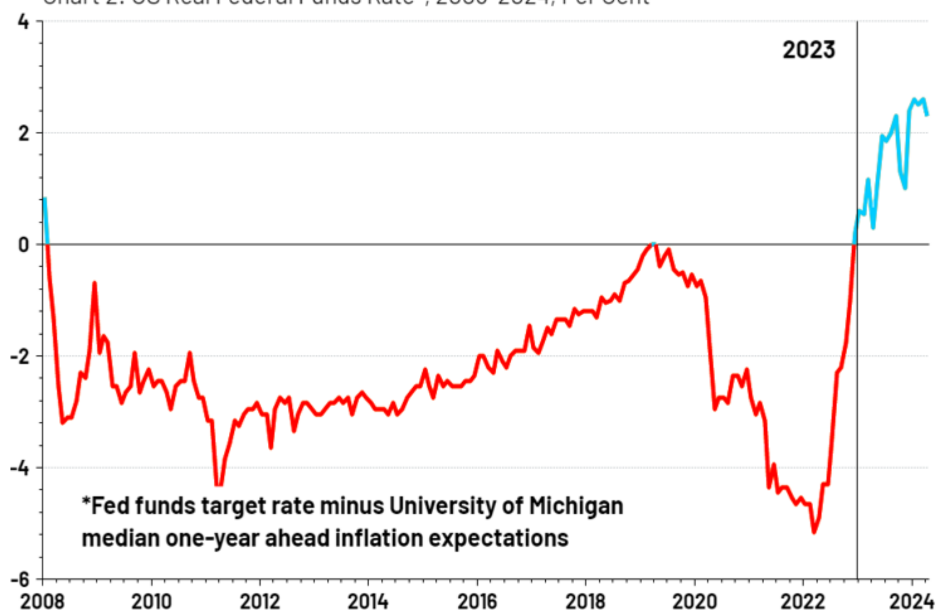
stocks, as gauged by the MSCI USA index, averaged a total return of almost 11% per year. But prolonged negative real rates also, ironically, created a set of perverse incentives that encouraged excessive risk taking for businesses and investors alike.

For companies, 'negative rates forever' encouraged excess debt accumulation and investment in projects with dubious potential returns. For investors, we would argue that the recent phenomenon of 'meme stocks' and 'SPACs' (special purpose vehicles that allow firms to use shell companies to go public, while sidestepping regulatory due diligence) were by-products of this 'cheap money' era.

Real rates below zero also have potential negative implications for any entity who owes a lot of money, whether sovereign or corporate. Even though low rates make it possible to service higher levels of debt, they also ensure that debt burdens grow over time in 'real' terms, all else being equal. This is particularly a problem for the developed world, as the US, Europe, and Japan are all aging, highly indebted societies to various degrees.

Most perversely, negative real rates penalized savers and anyone on a fixed income – including pensioners, retirees, and the elderly. Negative rates of real return mean that the value of every dollar you keep under the proverbial 'mattress' - in a savings account or in cash – is losing purchasing power. To this point, over the 2008-2022 period, the average real interest rate for US 10-year Treasury securities (adjusted for consensus expectations of CPI inflation, one year forward) was -0.66%…hardly a compelling investment.

For investors who were increasingly moving towards retirement during this era, the lack of positive returns available in 'risk-free' government bonds forced them into a Faustian bargain: either own a higher percentage of stocks than financial planning frameworks recommended - and risk losing their nest egg if stocks corrected - or watch the value of their low-risk assets get eroded away slowly as living costs increased.



Source: LSEG Datastream, RiverFront: data monthly as of April 15.2024. Chart shown for illustrative purposes only. Not indicative of RiverFront portfolio performance.

Patient Exiting the ICU – Investor Implications of a Return to Positive Real Interest Rates

The good news is that the US appears to have finally emerged from the dark age of negative real rates (see blue line, Chart 2, right). Since 2022, the 'patient' is slowly emerging from the ICU, as robust US growth and strong productivity is powering the US economy (see *Weekly View* from 2.27.24, for more on the US economy). This has allowed the Fed to aggressively hike rates over five percentage points, without plunging the economy into deep recession.

The process of weaning our nation off the proverbial 'painkiller' of low rates has begun, in our view. Like any recovery, it will be uneven and spiked with periodic episodes of discomfort. One such episode was the inflationary spike caused by supply chain disruptions in the wake of the pandemic… the after-effects of which we are still dealing with today. But overall, we think the world is better off in a more normalized rate environment… and long-term investors should take note of some of the wide-ranging implications of what we believe to be a structural move back to positive real rates.

We see this new positive real rate era as having a profound effect on several of major stock and bond market dynamics. Last week we discussed the greater investor emphasis on balance sheet strength and cash flow generation, as these things

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become more difficult for the average company to achieve in a higher interest rate environment. This is a trend that we think will disproportionately benefit mega-cap technology and tech-related companies (see last week's *Strategic View*).

In this week's installment of Gamechangers, we discuss how the 'reflationary' economic tailwind that is typically present in a positive real rate environment is likely to benefit certain cyclical value themes, such as US energy stocks.

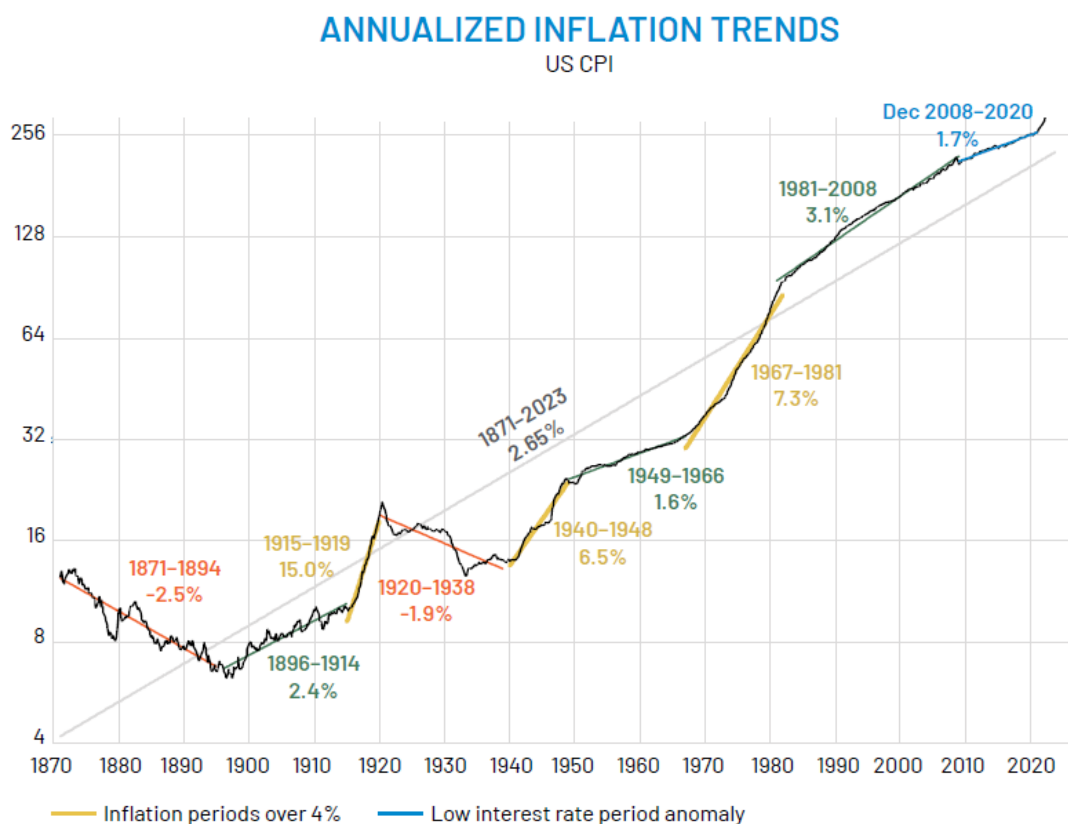
Gamechanger #2: *Growth and Inflation higher = 'Reflation' Trade in Certain Cheap Cyclicals*

Beneficiaries: *US energy, small-cap industrials, Japanese equities*

In December, RiverFront released its Long-Term Capital Market Assumptions, which are meant to give our views into major asset class returns through the next business cycle (defined by RIG as roughly five to seven years). Through this work, we make assumptions around key macro factors that will drive corporate earnings and valuations for various stock asset classes. Our Base Case (which we define as the highest probability outcome, in our view) is that of a mildly 'reflationary' US economy – one with a healthy level of economic growth, but also moderately elevated inflation and real interest rates compared to recent history.

To help define this 'Reflation' backdrop, we start with our long-term economic assumptions. The first – and one of the most important – factor we forecast is US economic growth. **In our Base Case, we view the US as growing at around 'trend' GDP through the next business cycle.** For context into our definition of 'trend,' US GDP growth averaged around +2.3% above inflation over the prior 7 years, despite a short but sharp recession caused by the pandemic shutdown. This assumption of trend growth is not a heroic assumption in our view, given the productivity advantages and resilience that the US has displayed throughout the last cycle (for more on this, see our *Weekly View* on US 'economic exceptionalism' from 2.27.24).

Chart 3: Inflation in the US Historically Higher Than Fed 2% Target



Source: Riverfront, BLS, Robert J. Schiller (before 1913), data as of October 31, 2023. Trend lines are RiverFront's best approximation and are subjective. Shown for illustrative purposes only.

Our longer-term view on inflation is another key input to our long-term forecasts. While we believe that the ultra-high inflation levels of 2020-2022 were related to pandemic imbalances and will continue to moderate over time, albeit somewhat unevenly, **we also believe core inflation will average above the Fed's current target of 2% over the next 5-7 years.** This slightly elevated inflation is related to a host of factors, including some changes in the global supply chain given increased geopolitical tensions between the West and China, Russia and others. These factors include the growth of 'onshoring' and 'friendshoring' (shifting supply chains to domestic or to geographies perceived as aligned with the US), periodic spikes in commodity prices due to unrest, as well as reasonable global economic growth.

We believe the abnormally low inflation levels experienced during the bulk of the 'Financial Repression' era from 2008 to 2020 (blue trend line in Chart 3, page 3 above) were an anomaly, driven by China's entrance into world trade. While the abnormal impacts of China entering the World Trade Organization will fade, we still anticipate inflation to remain relatively contained, due to the steady tailwinds of technological advances that should keep productivity high. Note from Chart 3 that inflation has trended at or above 2% per annum for most of the US's history, other than directly after WWII and two deflationary periods in the late 1800s and early 20th century (red lines in Chart 3).

Cyclical Stocks Such as Energy Prefer 'Reflation'

We believe this reflationary environment of solid growth and moderate inflation is where 'cyclical' - which we define as those comprising the industrial, energy, and materials sectors - stocks thrive.

These cyclical stocks have an interesting relationship with inflation. We believe that when inflation runs too hot (>5%) for too long, cyclical-oriented companies struggle to consistently pass those costs to customers. Additionally, since many cyclical companies are also dividend payers, higher inflation increases the attractiveness of substitutes, like bonds, money market funds and bank CD's. On the other hand, when inflation is too low, cyclical-oriented companies cannot grow their sales fast enough to cover their fixed costs.

Below in Table 1, we can see this dynamic at work historically. The second column (bordered in Table 1, below) represents months between 2013 and today when inflation was between 3% and 4% - our classic 'reflationary' inflation backdrop. While this reflationary zone occurred only 8% of the time, it provided the best average monthly return for a basket of Energy stocks that makes up the S&P Energy Select Sector Index. Note that energy stocks performed almost as strongly in months when inflation was higher than 4% as well…suggesting that inflation of all stripes tends to benefit energy companies.

Table 1: Inflation's Effect on S&P Energy Select Index Average Returns: January 2013-March 2024

	Less Than 3%	Between 3% and 4%	Greater than 4%	Full Period
Percent of Occurrences	70%	8%	21%	100%
Average Monthly Return of Energy Sector	-0.25%	2.28%	2.14%	0.48%
Percent Energy Sector Monthly Return >0	48%	60%	62%	52%

Source: FactSet, RiverFront; Data monthly as of March 2024. Charts shown for illustrative purposes. Not indicative of RiverFront portfolio performance. Past performance is no guarantee of future results.

Energy: A 'Reflationary' Story Whose Time Has Come, In Our View

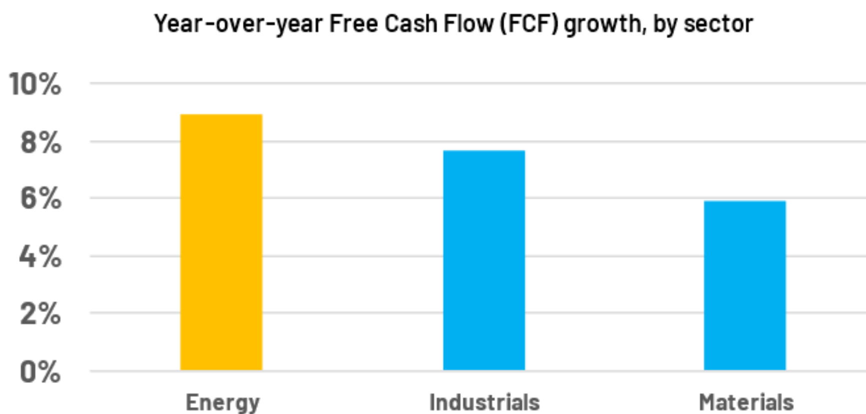
The past year has been a rough period for US energy stocks, as oil prices fell from the multi-year highs of 2022. However, we still believe that the sector is well positioned moving forward. We estimate new US 'shale' wells can produce oil for about $60 a barrel. Since we expect oil prices to average around $80-$90 per barrel, these wells should be very profitable for well-run energy companies.

Building on this theme, profitability has been improving recently for energy companies. Utilizing RiverFront's analysis of our proprietary global publicly-traded company database (which includes all S&P 1500 constituents as well as the 250 largest international companies, excluding financials and real estate firms), free cash flow (FCF) growth in energy over the last year is higher than for other traditional cyclical 'reflationary' sectors such as industrials or materials (see Chart 4, top of next page).

However, not all energy companies are equally attractive, in RiverFront's opinion. Referring back to themes discussed in our Gamechangers – Part 1 piece last week, in our view the big differentiator between individual energy stocks' potential for growth in a rising interest rate environment comes down to the health of their balance sheets...and specifically their debt rating and amount of debt.

We believe that less-indebted companies - and those with lower costs of servicing that debt - will be more able to make strategic capital allocation decisions to take advantage of any distress caused by elevated interest rates. These companies tend to have a lower interest expense burden, which can equate to less of a drag on free cash flow. Unlike technology companies, we typically assign a low future revenue growth rate to energy companies, so near-term cash flows make up a large amount of intrinsic value.

Chart 4: Energy – Highest Cash Flow of Cyclicals



Source: Factset Data Systems, Riverfront; data monthly, as of March 29, 2024. Chart shown for illustrative purposes only.

It's worth noting that while US energy is our preferred 'reflation' story, there are other global stock selection themes that also can benefit from reflation as well. A few of these include:

- **US small-cap industrials:** Inflation allows industrial companies to raise prices, which drives companies' revenues, while their cost structure is more fixed. In such environments cyclical companies are likely to experience a ramp up in their returns to shareholders, as revenue accelerates against a fixed cost base – this is called operating leverage. In an inflationary environment, we prefer the singular scope and more straightforward cost structure of smaller industrials, relative to their large-cap peers. Due to these features, we believe that small-cap industrials can utilize inflation-driven revenues to generate profits more effectively than large-cap industrials.

- **Japanese stocks:** The Japanese economy has recently broken out of a three-decade long fight against deflation; reflation is starting to awaken long-dormant 'animal spirits' among investors in Japan. We are heartened by the country's corporate reform efforts begun under late Prime Minister Shinzo Abe, as well as broad Japanese stock indexes' significant weightings to 'reflationary' sectors such as technology and industrials. Recent weakness in the Japanese yen may also help boost profits in many of these export-oriented business models.

- **Non-China Emerging Markets and Canada:** Many international economies are net commodity exporters...and thus tend to benefit from a reflationary backdrop as well. Canada and Latin American countries are two such regions. While we view US and Canadian companies' corporate governance and management to be generally superior to most of emerging markets, a 'reflationary tide may lift all boats' in this instance. We remain cautious on China (See *Strategic View* from August 2023 for more on this), but most of the rest of emerging north Asia -Taiwan and South Korea in particular- benefit from similar themes to US mega-cap technology. Southeast Asia is a likely beneficiary of Western 'friendshoring'. For its' part, India is now likely emerging markets' biggest economic growth 'gamechanger', supplanting its long-time rival China.

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Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issue. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

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Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Standard & Poor's (S&P) 600 Index tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. This is determined by specific metrics such as public float, market capitalization, and financial viability, among other factors.

Standard & Poor's (S&P) MidCap 400® Index is comprised of 400 companies that broadly represent companies with midrange market capitalization between $3.6 billion and $13.1 billion.

The S&P Composite 1500® combines three leading indices, the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®, to cover approximately 90% of U.S. market capitalization. It is designed for investors seeking to replicate the performance of the U.S. equity market or benchmark against a representative universe of tradable stocks.

The S&P Energy Select Sector Index is a stock market index that seeks to provide an effective representation of the energy sector of the S&P 500 Index. The index includes companies from the following industries: oil, gas and consumable fuels; and energy equipment and services.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 610 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

Definitions:

The energy sector is a category of stocks that relate to producing or supplying energy. The energy sector or industry includes companies involved in the exploration and development of oil or gas reserves, oil and gas drilling, and refining. The energy industry also includes integrated power utility companies such as renewable energy and coal.

The federal funds rate is the rate banks charge each other for lending their excess reserves or cash. Some banks have excess cash, while other banks might have short-term liquidity needs. The fed funds rate is a target rate set by the Federal Reserve Bank and is usually the basis for the rate that commercial banks lend to each other.

The term cash flow refers to the net amount of cash and cash equivalents being transferred in and out of a company. Cash received represents inflows, while money spent represents outflows.

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

Mega cap is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion.

Gross domestic product (GDP) is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time.

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