Talaria Global Equity Fund (Managed Fund)

Quarterly Update September 2024

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Investment Insights

It is easy to say that economies and markets are cyclical, but pinpointing their exact stage and gauging their amplitude can be challenging. For instance, while there appears to be less of a debate around timing, there is still considerable discussion about the amplitude of the current economic cycle. Some believe any slowdown will be shallow, whereas others anticipate a more pronounced range from peak to trough.

We are sceptical of forecasts, and we have said before that rather than seeking a definitive answer, rather than coming down hard on one side of a debate, we are trying to construct a probabilistic framework. It is in this spirit that we share observations relating to past cycles, that we believe help with judging the odds and probabilities that investors face today.

Among other things, what we find is that certain risks are probably underestimated. For example, with absolute prices still high but inflation slowing and unemployment rising we are likely to see a period of weakening corporate earnings that is at odds with the optimism in numbers. Consensus forecasts are for S&P 500 earnings per share to be 312 in 2026, 44% higher than 2023 earnings per share.

Whilst there is no playbook to guarantee good outcomes, we also find that there are certain factors and sectors that generally do better or worse after the first cut in official interest rates. In this context, the recent change in market leadership makes sense. Although the performance picture is complicated, investors have certainly rotated towards stability - utility companies have strongly outperformed every other sector since April 2024.

Before exploring these risks further, it is also worth recapping the well-known phases of a typical cycle, beginning with phase one's economic expansion from a growth trough, usually marked by rising asset prices in anticipation of improving corporate profits and by relatively loose monetary conditions. During this phase, the market rally is broad-based with most equities moving higher driven by multiple expansion.

The second phase is marked by the economy growing and asset prices rising driven predominantly by the reality of growing corporate profits. Interest rates are typically rising in this phase.

The third phase follows when interest rate expectations and GDP growth peak. As GDP growth starts to slow, assets perceived as having structural growth become relatively more valuable. Investors are willing to pay a premium to own companies that are thought to be insulated from slowing cyclical growth. Market leadership narrows and becomes concentrated in fewer names.

The first interest rate cut typically signals the start of the fourth phase of the economic cycle, often bringing a shift in market leadership. This is also the point where growth traps are most likely to occur. While growth traps have a lower profile than value traps, they are equally valid and significant.

The concept hinges on the idea that some companies can deliver growth well above GDP and the market average, yet still have shares that disappoint. This is because the expectations embedded in their initial valuations are too high. What proves, in hindsight, to be over-optimistic expectations have been mis-calibrated due to an underestimation of the cyclicality that impacts nearly all companies.

Each market cycle is driven by a different structural growth theme that tends to be resilient. The potential danger for investors at the current point of the cycle is in continuing to chase today's theme even as the market environment changes.

The financial industry exacerbates this risk as it is heavily invested in the broadest sense of that word. It can keep pushing these structural growth trades well into the fourth stage, whether through sincere belief or from extrapolating recent performance, couching the rationale in what has seemingly become self-evident to all market participants. The industry is further incentivised by the high volumes and commissions that trades around this theme generate. Often it takes a significant drawdown or even a crisis to put an end to all this.

Unemployment matters

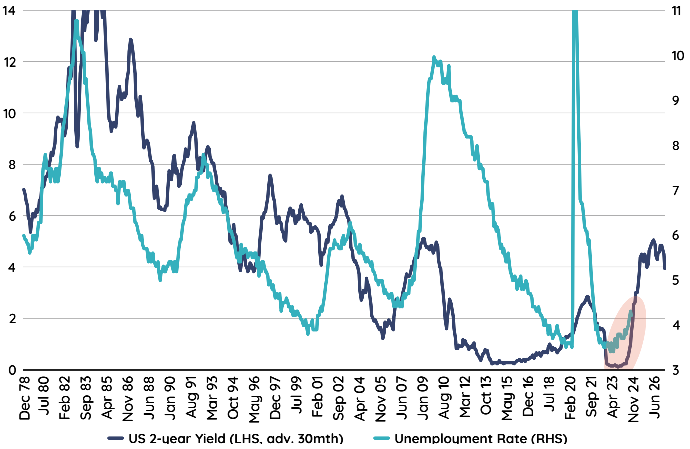
In terms of identifying the stage and likely amplitude of the current cycle, unemployment is a key indicator. More precisely and for obvious reasons, US unemployment trends are significant.

A weakening labour market matters because, as we have seen in the past, it can trigger a cycle of falling consumer confidence that in turn leads to lower spending, hurting corporate revenues. Lower revenues can lead to more layoffs as companies try to protect profits and so on until the economy tips into a recession. The US is at particular risk since its consumption-driven economy, where consumption accounts for about 70% of GDP, is highly sensitive to rising unemployment.

The monetary tightening initiated by the Fed in March 2022 is clearly having a negative effect on US employment today. The chart below shows the strong relationship between US two-year yields, advanced 30 months, and unemployment. If this relationship continues to hold, unemployment is likely to rise further.

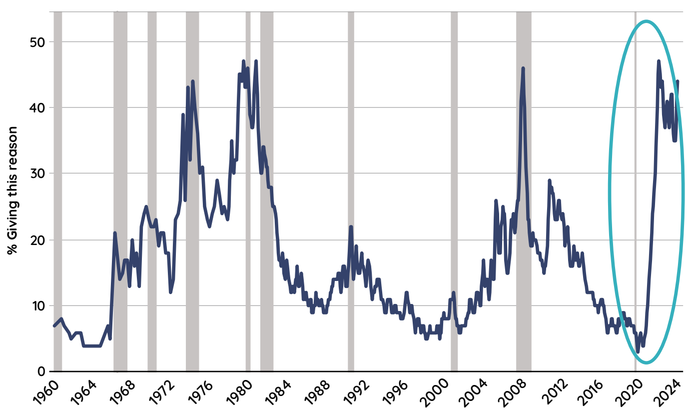
Other metrics that measure the health of labour markets may also raise concerns. The quits rate has hit a new cycle low of 1.9% - people are reluctant to leave their jobs because it is hard to get another one. The Conference Board's Jobs Hard minus Jobs Easy survey has hooked up and suggests a further increase in unemployment.

US 2-Year Yield Leads Employment By 30 Months



Source: Federal Reserve Bank of St. Louis

Univerisity of Michigan Survey of Consumers: Higher Price as Reasons for Worse Personal Finances



Source: University of Michigan

In terms of gauging the risk, when US unemployment has increased by 0.6% from a cycle low, a recession has followed – without exception. This pattern has held true in all 12 US recessions since World War II. In the current cycle, the unemployment rate has already risen by 0.7%, reaching 4.1% in September 2024.

High prices and low inflation offer a problematic combination

Inflation, the rate of change in prices, is clearly slowing across developed markets. Core inflation in the US, which excludes volatile food and energy prices, was up just 3.2% year-on-year in August, the lowest since April of 2021.

Inflation expectations are down as well. The US 5-year breakeven inflation rate, a proxy for expected inflation, is just 1.94%, down from 3.57% at its peak in 2022. This is a whisker under the 2% Fed inflation target. Other developed economies are experiencing similar moderation in inflation expectations. This seems to be taken as purely good news, but the picture is more complex.

While the pace of inflation has indeed slowed, the absolute price level remains high and burdensome, especially for essential, non-discretionary purchases. Prices in the US are up over 20% in aggregate since the start of COVID.

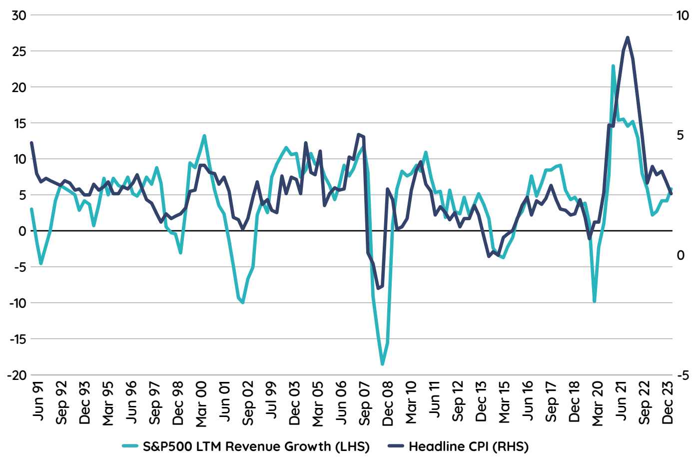
Consumers are hurting. Responses to the University of Michigan's survey on "Higher Prices As Reasons For Worse Personal Finances" rose again in July to near 50%, returning to the peak levels seen when headline CPI was at 9.1% back in 2022 (see chart).

One of the reasons inflation matters is because it is positively correlated with nominal corporate revenue growth, given revenue is simply units times price.

Since inflation is in part a measure of the change in prices corporates charge, it should not come as a surprise that when inflation falls, corporate price growth also falls. At the same time, the punitive absolute price level is hurting real consumption, suppressing volume growth and further clouding the revenue outlook for US corporates.

The relationship is evident in the chart below. High inflation accelerated nominal revenue growth for S&P 500 companies in the years after COVID. Lower inflation is having the opposite effect today.

S&P 500 Revenue Growth & US Headline CPI (YoY %)



Source: Bloomberg

Corporate earnings appear set to disappoint

Against the unemployment and inflation backdrop, it may be a surprise that consensus forecasts are for S&P 500 earnings per share to be 312 in 2026. This is 44% higher than 2023 earnings per share. We can think about the likelihood of these forecasts materialising in two ways, bottom-up and top-down.

Bottom-up

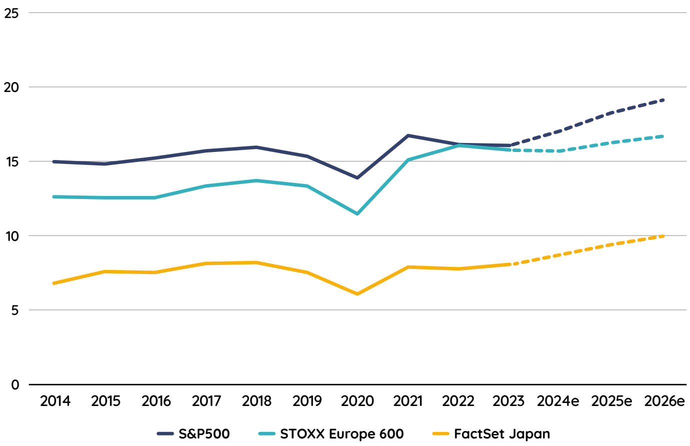
Mathematically, four things drive earnings higher – revenue growth, EBIT margin expansion, lower interest expense and lower tax. It shouldn't be controversial to assume that there are neither head nor tailwinds from interest or tax, in which case 2026 earnings growth relies entirely on the remaining two drivers.

Revenues are estimated to grow 18% by 2026, or around 6% per annum. This compares to 3% growth in 2023. We have already argued that a re-acceleration in revenue growth would be difficult when inflation is trending lower and the consumer is hurting from the absolute price level.

The optimism surrounding EBIT margin expansion is even greater. Consensus forecasts are for the margin for S&P500 companies to expand from an already elevated 16.1% in 2023 to an all-time high of 19.1% in 2026, 300 basis points higher. Such expansion is estimated to contribute 22% over the three-year period to earnings growth, or 7% per annum. Because growing revenues are amplified by expanding margins, earnings per share grow even faster than the simple sum: (1+18%)*(1+22%)=(1+44%).

Optimism on margins is not isolated to the US alone. Other developed regions are seeing similar trends. In the chart below we look at EBIT margins across the US, Europe and Japan. All three finished 2023 with margins near historic highs and in all three forecasts are for margins to hit all-time highs by 2026.

EBIT Margins (%) 2014 - 2026(e)



Source: Factset

The optimism is not isolated to a particular sector either. In our June 2024 quarterly report, we showed that every sector except utilities is estimated to see margins expand over the next two years.

Top-down

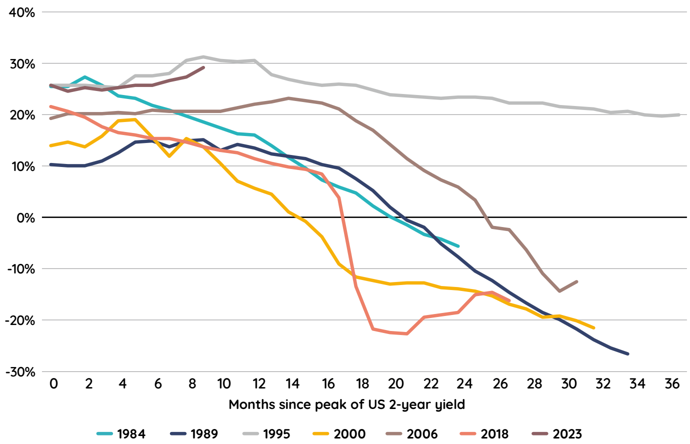
Earnings disappointment seems odds on from a top-down perspective, too.

It is very normal for earnings growth estimates to be elevated at the peak of two-year US bond yields. This has been the case every single time since consensus figures came into existence in the mid-1980s.

The seven coloured lines in the chart below show the progression of consensus estimates for two-year growth in S&P500 earnings per share following the peak in two-year US bond yields, month zero. At that point, earnings were forecast to grow by between 10% and 25% in the first full forward two-year period in all seven cases.

Fast forward 30 months and reality painted a different picture. In five out of six completed instances the actual two-year growth in earnings turned out to be negative. On average, the actual two-year forward earnings per share ended 28% lower than the initial consensus forecast. The only time that two-year forward earnings did not see significant downgrades but grew in line with the initial estimates was the 1995 soft landing (see blue box for details on why the 1995 backdrop was very different to the backdrop today).

2yr EPS growth, post end of tightening



Source: Piper Sandler

The 1995 soft landing that propelled the S&P500 higher was different to today in three important ways.

First, the labour market was booming in 1994/95. Unemployment had decreased from 7% in 1993 to 5% in 1995, and was still falling. Today, unemployment has already troughed and is rising.

Second, monetary policy is far tighter today than it was in 1995. The yield curve never inverted back then. It has been inverted since 2022 in the current cycle.

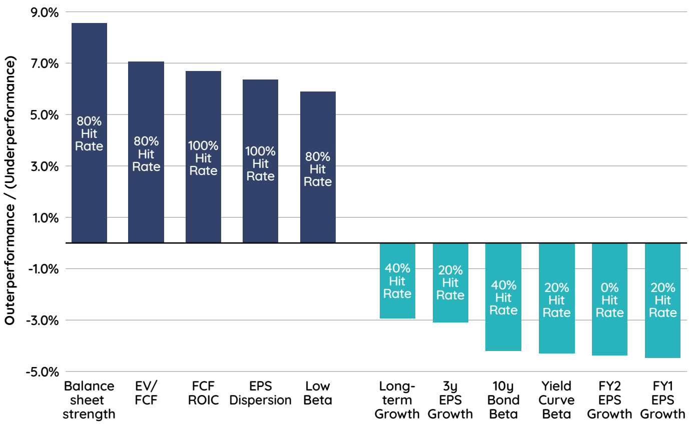
Third, the Conference Board Leading Economic Indicators index posted precisely one month of very modestly negative year-on-year growth in January 1996. In the current cycle, the index has been in negative year-over-year territory since mid-2022.

In the past, when the Fed cuts rates, growth underperforms; stability outperforms

Whatever the earnings outcome, history suggests that what performs well after the first Fed rate cut is different from what did well before.

The chart below shows that four of the six worst performing factors in the 12 months following a rate cut are growth related. The average underperformance for these factors in the five cycles we looked at was between 3% and 4%. What is interesting is not only the absolute underperformance, but that the hit rate is very low in every instance (a hit rate of 0% means that the factor underperformed in all five instances).

Factor Performers - 12 Months Post Interest Rate Cut



Source: Talaria, Société Générale

Conversely, factors that perform best centre around stability. Since an easing monetary cycle typically coincides with a weak economy and declining corporate earnings, factors like balance sheet strength, high cash flow and low earnings variability become very important. The outperformance for such factors is typically between 6% and 8%, with a hit rate of 80%-100%.

The final piece of quantitative work we did was to look at which sectors consistently outperform in a Fed easing cycle. It should not come as a surprise, given the factors discussion, that Healthcare and Staples came on top of the list. Companies in these sectors epitomise stability. In every easing cycle since 1990, Healthcare and Staples have outperformed on average by nearly 1100 and 900 basis points, respectively.

Conclusion

As we have mentioned in this and other reports, rather than trying to predict the future, we find it more effective to apply a probabilistic framework to identify where the greatest risks to global equities lie, whether to the upside or the downside.

We have demonstrated that the balance of probabilities indicates earnings estimates in the US are overly optimistic. Historically, this phase of the cycle, characterized by falling interest rates and rising unemployment, tends to coincide with weakening corporate profits. Moreover, lower inflation often translates into reduced revenue growth for companies. Amongst other things, this increases the likelihood of growth traps.

Given this backdrop, we have also analysed which factors tend to perform better or worse after the initial rate cut. Thinking in terms of odds and probabilities means accepting that anything can happen. Nevertheless, our work suggests that risk management and rotation towards stability remain key considerations for investors.