NAPLES GLOBAL ADVISORS

MARKET INSIGHTS

FIRST QUARTER 2022

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Out of the Frying Pan and into the Fire

The first quarter of our new year has provided us with no shortage of topics for discussion. **Again.** As with relatively recent history, the markets were roiled by a seemingly endless stream of bad headlines, creating yet another wall of worry for investors to contend with. Starting with the first trading day of the year, the hits came quickly—from collapsing supply chains and soaring inflation, to war on the global stage. After a sharp drawdown in many stocks (particularly in large swaths of "growth" companies with no profits), we saw a significant bounce off the lows for most global equity markets. The chaos once again puts all of us in the position of asking "now what?"

How do you eat an elephant? **One bite at a time.** And while we're not actually advocating for elephant steaks, the concept of approaching a monumental issue in small manageable pieces is how we can make sense of the fresh turmoil currently at our doorstep. The issues at hand are just that—monumental—but our objective is to successfully navigate towards the potential outcomes of those issues, not to solve them or to guess what will happen. Months before Russia invaded Ukraine, the proverbial cracks in the prevailing market narrative were beginning to show. Inflation expectations had been surging with little reaction from monetary authorities. Oil was flirting with an $85 per barrel price tag as far back as November of last year. Even the market darlings of the post-lockdown rally were falling back to earth. The nearby chart shows a Goldman Sachs-tracked basket of profitless companies, who after rallying strongly throughout **2020**, began a painful decline in **March of 2021**. Russia's invasion of Ukraine may not have been the cause of these trends, but clearly acted as an accelerant. The acceleration of those trends did force a long-needed admission: transitory or not, things (inflation, supply chains, global trade, etc.) were unlikely to quickly return to the "normal" we saw during the globalization boom years. Fortunately, the first step to healing is admitting there is a problem.

Goldman Sachs Basket of Profitless Companies

Source: FactSet

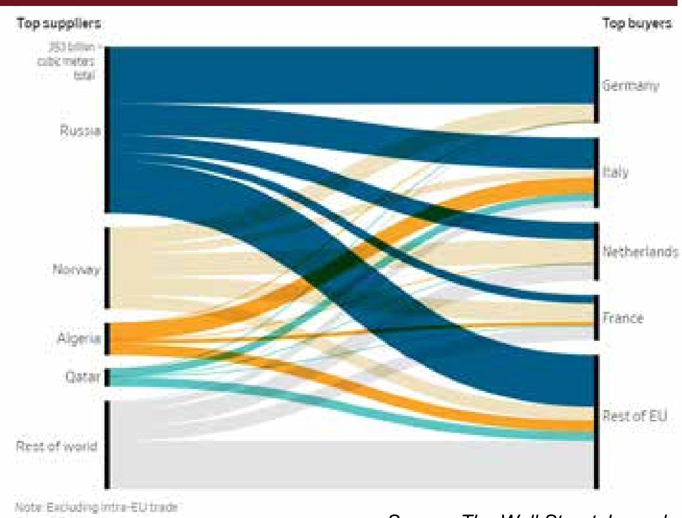
The elephant we are currently facing is half geopolitical and half monetary. Geopolitically, the goal is to navigate portfolios through a period of time where a "hot war" in an extremely precarious location has the potential (albeit unlikely) to escalate to a truly global calamity. Monetarily, the goal is to navigate portfolios through a period of time where inflation is approaching lifetime records, interest rates are lifting off, and global trade is fundamentally changing. The objective is to thoughtfully prepare for a variety of iterations of what may happen, not to predict the exact course of the future. Thus, generally pre-positioning well in advance, we prepare—**one bite at a time**.

The impacts on markets and businesses from the war in Ukraine can essentially be broken into three categories: **physical impacts, globally "direct" impacts, and globally "indirect" impacts.** For investors, avoiding the **physical impact** of war is relatively simple—don't invest in companies with assets or operations in the areas facing conflict. Between the strict fundamental constrains we use before considering a company for investment, and the on-site visits to our more "off the beaten path" targets, our investment opinions of both Russia and Ukraine have never really improved from "thanks, but no thanks." Even before the current conflict, a healthy dose of persistent corruption in both countries kept us from participating in the regions. An ounce of prevention is worth a pound of cure.

The **direct impacts** from the war are also relatively simple to identify and prepare for. For example, when a government needs fighter planes, drones, and bombs, companies that manufacture those items do well. Look no further than the recent price performance of defense contractors and manufacturers for evidence of this development. Alternatively, aggressive sanctioning of a country with the population and GDP of Russia will obviously have negative impacts on the global companies that operate locally. A quick-hitting announcement from McDonald's outlining their shuttering of operations in Russia is a clear example. If there is direct impact on business operations, the key is to identify the extent of that impact and adjust accordingly. In McDonald's case, less than 5% of global revenues are derived from the Russian Federation, so their shuttering of Russian locations should have only a modest impact to the business.

Identifying the **indirect impacts** from the war and global sanctions is a bit more complex, but the clues lie in what is easily identifiable. Namely, Russia is an impactfully large supplier of energy (oil and gas), gold, wheat, copper, and other globally consumed commodities. Russian supply of energy to the European Union (EU) is a particularly touchy subject, since as the nearby chart shows, nearly 40% of all gas supplied to the EU is from Russia. If Russian natural gas is barred from some global markets by sanctions, should we expect global natural gas prices to go down or up? Probably up. The question then becomes: "what companies can we invest in that might benefit from those higher prices?"

Top Suppliers and Buyers of Natural Gas to the EU, 2020



Source: The Wall Street Journal

The point of the simplification exercise is to paint a picture of how we prepare for the future, without trying to predict it. Geopolitical events such as wars are typically a shock to markets, causing short-term displacements and mispricing. That's why our goal at NGA has always been to own "shock-resistant" companies that can weather the initial impact of economic shocks but adapt and resume growth once the dust begins to settle. Our "know what you own" mantra is composed of fundamental due diligence that starts with the simple question of "is this company's product or service in growing demand?" If the answer is a resounding yes, the chances are very good that demand will resume once tensions subside. The further requirements of low debt, strong margins relative to competitors, growing net profit, and compelling cash flows all lead to portfolios comprised of shock-resistant businesses that adapt and thrive. While the companies in which we invest are not immune to price turbulence, the underlying businesses typically have staying power.

The recent high inflation and responding interest rate hikes are also a type of shock that could have a significant impact on a portfolio if not prepared. We've been hearing that "inflation is coming" for quite some time now, and with a bit of a grimace we can confidently report that it has arrived. To combat that inflation, the Fed is signaling an aggressive rate hike schedule, with the first hike already implemented. It is widely expected that by year-end, short-term interest rates will be meaningfully higher. For reference, the Fed was still easing (pushing liquidity into the monetary system) as recently as mid-February, while holding short term rates between 0.00% and 0.25%.

How have we prepared for inflation and tectonic shifts in global funding markets? **One bite at a time**! Short durations in our bond portfolios and a broad ownership of coupon-paying (cash flowing) bonds have been key tools in mitigating the risk posed by quickly rising interest rates. Additionally, our long-standing practice of owning mostly individual bonds means that we know when cash will be returned from bond maturities, allowing us to reinvest those proceeds at higher and rising rates. A key component of our equity due diligence is avoiding heavily indebted companies since their refinancing costs will increase dramatically as a result of higher interest rates. Finally, a terrific side effect of our low-debt, value-focused approach to equities is that those cash-flowing, shock-resistant businesses have a habit of raising their dividend payments. On average, our top 20 equity holdings have increased their dividend payments by 11% annually over the last 3 years, and by 15% annually over the last 5 years! We expect the trend of dividend increases to continue, and those increases should go a long way in helping to offset the impacts of inflation.

We cannot predict the shocks or the outcomes. We can only discipline our analysis to uncover and purchase securities we think are truly durable and more than likely to withstand this or any other crisis de jour. That disciplined analysis with due diligence is exactly what we have done for our clients, and exactly what we will continue to do for our clients—**one bite at a time**.

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