Equity investing in an inflationary environment

Inflation is not necessarily bad news for equity investing. 'Sustainable dividend growth can offer inflation protection', Christophe Braun, Equity Investment Director at Capital Group states. He considers the effects that inflation have had on equity valuations, and reviews ways to build resilience in portfolios.

By *Jan Jaap Omvlee*

For the very first time in their lives many investors are now facing an issue they have not experienced before: inflation. We asked Christophe Braun: what is the importance of an active approach in light of key themes and trends on the horizon, such as the great rotation, inflation and geopolitics, and globalisation?

'We are in a market that is suddenly fundamentally driven, versus partially synthetic and artificial market drivers that we have seen over the last decade. The market fundamentals have changed, from helicopter money and continuous growth, where passive investing was doing very well, to today's situation, in which market fundamentals are dominating again. When you talk about geopolitical uncertainty, we are again questioning the globalisation that we have embraced so much over the last decade.

The other trend that we see, is the great rotation, triggered by macro drivers, and I would label that as one of the primary challenges for investors. It is more difficult to predict the market environment. That is why it is crucial to pay attention to company fundamentals in order to identify those all-weather companies which are able to navigate through the uncertain times that we all face. And this is where we believe that fundamental research is vital.'

Could you elaborate on equity investing amidst rising inflation and explain why inflation is not necessarily bad news for equity valuations?

'The conventional wisdom of inflation being a bad thing for equities and bonds markets is not necessarily true. Global equities have historically provided an effective inflation hedge when US inflation was between 2-6%, powered by real earnings growth and real dividend growth. Even during times of higher inflation, stocks have generally provided positive real returns. It is mostly at the extremes – when inflation is above 6% or negative – that global equities have tended to struggle. It is obviously key how those different variables in the equation interact, one of them being central banks, the other one being interest rates or inflation.

It's a very powerful dynamic having those all and trying to find that sort of middle ground, that equilibrium in the current market environment. And then there are other factors such as the war in Ukraine, energy prices – which as we all know are not always just dictated by supply and demand, since there are other variables and drivers that come into play, such as OPEC –geopolitical uncertainty and the awareness that Europe has become very dependent on the supply of gas from Russia.'

What is the actual impact of the current high inflationary environment in Europe and what does it mean for investors?

'There is uncertainty and a change to the playbook that we have known for the last few years. Investors therefore need to start looking out for different company characteristics and look at exposure to help mitigate inflation risk. History is helpful in this context, because there are clearly sectors and companies that can help you mitigate those challenges. Pricing power and higher operating margins definitely help. Strong market share and higher barriers to entry are supportive too. We look at the characteristics and how high or low the standard deviation is of those companies and sectors in relation to inflation and how much higher prices impact their profit margins. Obviously, with regard to market share: how indispensable are their products and services? And then there is this aspect of value companies outperforming growth companies since the end of 2020.

As investors are becoming more risk adverse, they are looking for sectors and companies that provide more defensive and quality characteristics, for instance utilities and traditional health care, where companies traditionally have strong pipelines, having patterns that would exactly protect those recurring earnings and revenues. History repeats itself, but not quite similar as markets are evolving. When I look at what globalisation has brought to the table, semiconductors have become vital for the digital transition with everything becoming more tech-related. You cannot do without semiconductors anymore, so there are sectors that have become the 'new defensives' so to speak.

These weren't defensive sectors 20 or 25 years ago as they were not generating any recurring earnings, or any positive earnings at all. While history guides investors to ask whether the traditional value-growth rotation cycle has simply extended, the influence of secular changes in driving valuations is hard to ignore. Today, they have significantly matured and I often describe them as being 'modern utilities', with newer generations consuming the Internet or IT infrastructure similar to the way that older generations have consumed gas, electricity and water, with access to internet being much cheaper.'

The relationship between inflation and stock prices is not linear. The impact of inflation on earnings can be quite positive in nominal terms, especially over the longer term, while the impact of inflation on valuations varies depending on the level of interest rates and the economic environment. Can you explain why?

'The impact of inflation on earnings can create short-term headwinds for corporate cash flows, particularly for companies that report earnings on historic cost accounting.

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CV

Christophe Braun

Christophe Braun is an Investment Director at Capital Group (Luxembourg) with responsibility for covering equities. He has twelve years of investment industry experience and has been with Capital Group for six years. He holds a Master's degree in Financial and Industrial Economics from the Royal Holloway University of London and a Diploma of Science in Business Management and Economics from the University of Innsbruck.

That differs from the impact of inflation on valuations, depending on the level of interest rates and the economic environment. In addition, interest rates remain well below their long-term averages. When these low rates are used to discount the present value of future earnings, they effectively boost the value of longer-duration growth stocks. The longer-duration feature means their cash-flows are weighted further out into the future than value stocks' which makes them more sensitive to changes in interest rates.

Also, something that is worth mentioning here, is that growth in intangible assets has made determining intrinsic value increasingly complex. This requires a bottom-up approach to understand a company's true value. If you look at the sector rotation that we have seen, it is because of that fear, that we saw central banks going into a rising rate cycle again at the beginning of the year. As a result of that, many 'go go-growth' companies, in some ways technology-related, with long duration earnings, are obviously coming under pressure in the current environment.

As the markets are now pricing in a recession, this makes it much more difficult for those growth-oriented companies to justify their forward earnings because these have become more uncertain. Companies that don't rely on future earnings, but are in a more mature business cycle where they have recurring earnings, are not necessarily >

growing. That's okay because they have a certain market share and are a dominant player within their industry, as they have blockbusters that are indispensable in terms of services and products.'

What steps can investors take to mitigate the impact of inflation on portfolios?
'It may start with understanding the dynamics of inflation, whether it be middle ground inflation or more on the extremes, and what the implications of this are on their portfolios. From an equity perspective, it starts with making sure as an investor that you understand how inflation can hurt a business. As inflation is so unexpectedly high, many companies were not prepared for this type of inflation. There's organic inflation, obviously energy prices, but there are also supply chain issues and the fact that supply chain issues have also increased prices in areas where they didn't necessarily have to increase prices.

Now suddenly everyone is caught in the same inflationary dilemma. As growth has become more limited, investors should look for more defensive quality companies with solid balance sheets, and for companies that are able and willing to pay out their earnings on a more consistent basis. I think we're in an environment where 'boring is beautiful' again, as they say, unlike in the past decades, when capital appreciation was the main driver of total return.'

Why should investors invest in dividend growth stocks now?
'Historically, dividend growers have tended to generate greater total returns, especially on a risk-adjusted basis, than other dividend strategies, while also keeping up relatively well with the broader market. Dividend growers can also offer a measure of resilience against higher inflation and interest rate hikes, mainly due to their stronger earnings. Semiconductors are a perfect example of that. There's still this huge demand for them and not enough supply for this world. As we try to equip the world with more IT infrastructure, they have a huge growth runway. Communication services as well. On the other side, those companies have understood how to transition from a big growth generator into a great capital allocator.

Semiconductors are interesting because they are a sub industry of the tech sector, with the tech sector being more volatile because of ambitious earnings, high expectations and forward earnings, et cetera. They have lots of characteristics that makes them defensive while they, as true hybrid growers, have been able to back up their dividend growth by organic earnings and maintain their yield.

Apple, for instance, which is on top of the value chain and able to forward high prices. Look at their new iPhone 14. Guess what? It has become even more expensive than its previous model. In addition, some of these hybrid growers come from a low-cost base. This makes dividend growers a very appealing investment proposition from a total return perspective.'

Where do you see opportunities to unpack dividend growth?
'Traditional healthcare has a track record of being more reliable and more resilient due to its patents and its strong research. The sector is also very disciplined in allocating capital and investing in future growth opportunities. If you look at which sector has provided most dividend growth within recent years, it's the IT sector, because many firms are able to back it up with organic earnings.

The IT sector has become very important for all of us in our daily lives. Companies are much more nimble with that innovative angle. They are disruptive and won't take no for an answer. Amazon is the best example here. They are not the online bookshop that they used to be. They conquered cloud computing after e-commerce was introduced. Today it's Amazon Web Services (AWS) dominating their revenue streams and that's the logical consequence of a company that stretches boundaries and goes beyond its growth target.

There are opportunities in any company where dividends are not artificially high and that's still able to back up its dividend with growth and organic earnings. Next to healthcare, the energy transition will also offer interesting opportunities for utilities to find new growth pockets and offer super attractive growth prospects.' ■

SUMMARY

Companies whose top line can 'inflate' at a higher rate than their costs are well positioned to do better in a higher inflationary environment.

Such companies are also more likely to improve their capital allocation by expanding return on equity for shareholders and consequently improving dividend payout.

There are investment opportunities in any company where dividends are not artificially high while still being able to back up its dividend with growth and organic earnings.