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Investment Insights

Growth that matters: investing in a world in transition

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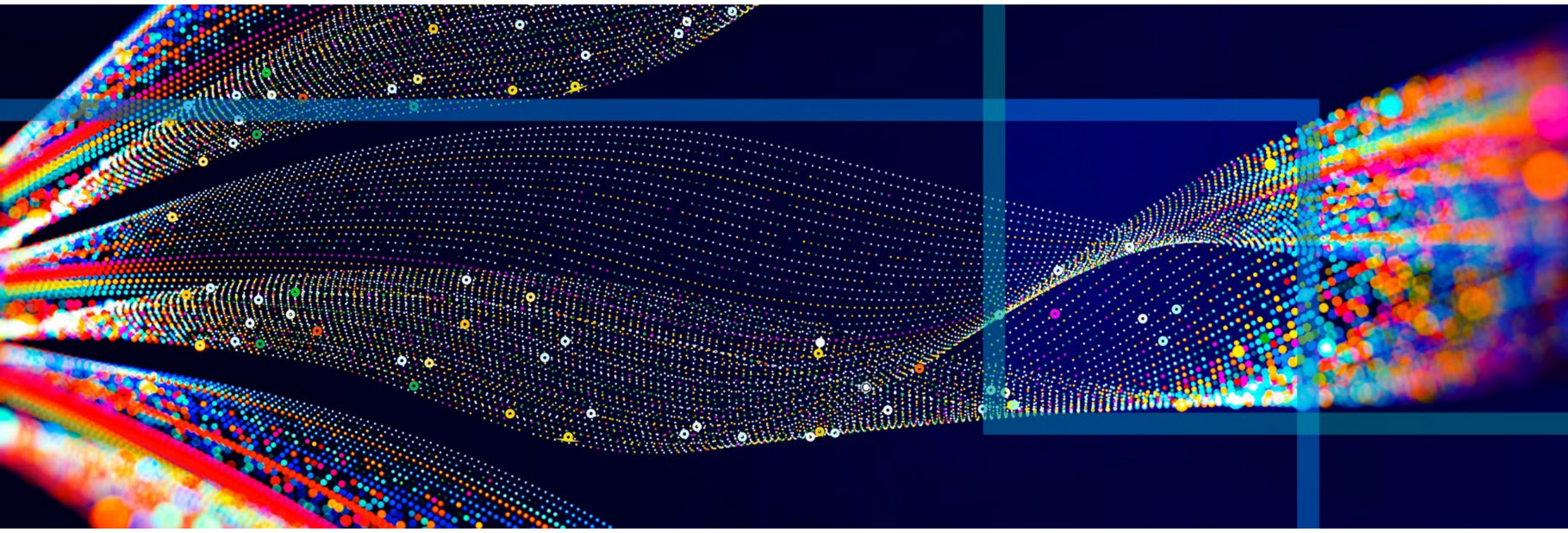

Growth that matters: investing in a world in transition

Jody Jonsson
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Key takeaways

- More geopolitical shifts that could lead to structural changes in the global economy could materialise in the coming decade.
- Rigid classifications such as value and growth have their limitations and may not be the most accurate reflection of a company's business.
- Innovation and technology can continue to thrive and generate attractive investment opportunities in the current environment.

Today, interdecadal shifts are happening on three fronts – inflation, interest rates and geopolitics. This confluence of factors has triggered a change in equity market leadership (from growth to value stocks) and inadvertently created a rapidly changing investment backdrop, generating challenges as well as opportunities for investors. In this paper, we spoke with several Capital Group investment professionals to gather their thoughts on the global economy and understand how they are investing in a world in transition.

Harold La
Equity Portfolio Manager

Anne Vandenabeele
Economist

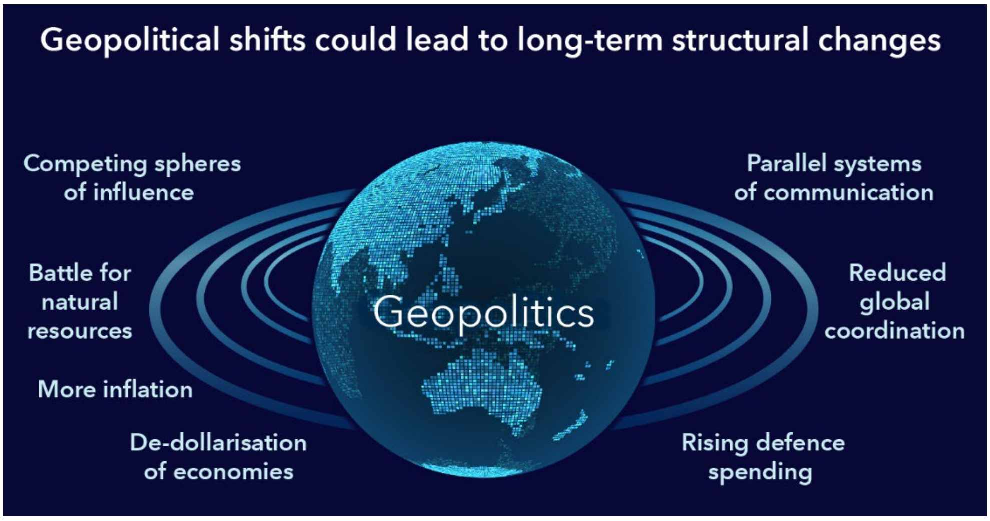
Anne Vandenabeele

Geopolitical shifts could lead to long-tern structural changes

Anne: We are living in a world where changes are occurring across all aspects of the global economy. But in terms of prominence, I would say geopolitics would be up there at the top of the list. This is now a world where US-China political tensions have accelerated the reorganisation of supply chains and where governments are prioritising national as well as economic security over business efficiencies and corporate interests. It is also a world where the Russia-Ukraine war has disrupted energy supplies, accelerated energy transition plans in Europe and pushed inflation as well as interest rates to multi-decade highs. We are essentially transitioning from an era of cheap money to one with higher financing costs and we are finding out where the fragility is within the global economy as well as financial markets.

Another question to ask is whether we could see even more changes in the next decade? What are the possibilities of two separate competing systems and spheres of influence? Could we, for example, see the establishment of a Western "Belt and Road" that could trigger more strategic investments in South America, Africa, and Southeast Asia to secure access to resources and geopolitical alignment? Or perhaps the start of another arms race where there could be heightened competition not only across weapons development and cybersecurity but also other areas such as science, finance, and technology.

No one knows for sure. What we do know is that geopolitical shifts are occurring – some of which are likely to be structural and could generate plenty of challenges, as well as opportunities, for investors. Given the complexities and confluence of factors at play, it is important to analyse these developments through multiple perspectives. Multiple perspectives mean investors can leverage a diversity of inputs, a diversity of opinions, and factor them into building their portfolios based ultimately on where they have highest convictions. In this increasingly fluid world, not anchoring investment decisions on a single perspective can potentially be a great source of strength.



Jody Jonsson

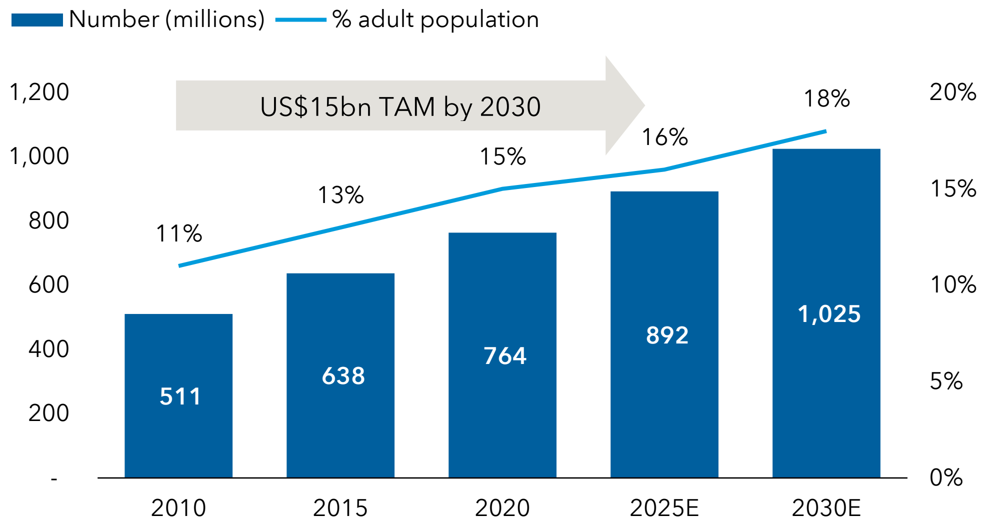
Growth investing isn't dead

Jody: Geopolitics are going to have a larger influence in terms of the multiples that we pay for companies. Given what has been happening across the world, it is clear we have to apply a geopolitical discount that was probably not required as much over the past couple of decades. An example would be companies with a lot of exposure to China. We need to be considering the type of products they are selling and whether that might be the focus of future geopolitical tensions. If they are, what is the degree of sensitivity, what are the possible repercussions and how much of a discount do we apply based on the different scenarios?

I wouldn't go as far as saying that these are unprecedented times. We have experienced periods before in which both equity and fixed income markets generated negative returns. But the world is clearly in transition and one concept investors are contemplating is that high-growth companies can be cyclical – a notion that had been lost somewhat by an extremely prolonged period of low interest rates and volatility. Even the cloud space, which had been an incredible source of growth, is proving to be economically sensitive as more companies consider the type of services they wish to outsource or keep in-house.

Still, just because growth stocks are out of favour does not mean that growth investing is dead. Growth and innovation can continue to prosper. We are seeing that in the health care sector, which is in the midst of a golden age of drug discovery with significant markets emerging in areas such as obesity and dementia. Obesity was something that drugmakers were researching more than a decade ago, but we were still far from reaching any sort of breakthrough back then. The landscape has really started to change in the last year or so with some of the new drugs on the market producing very encouraging results. It is exciting to think about what could happen if we solve obesity because of all the other diseases that come along with it, including diabetes, hypertension, and heart conditions. This could be huge, not only for human health, but also in terms of cost savings across the health care industry.

Obesity is a global health emergency



Forecasts are shown for illustrative purposes only.

TAM: Total addressable market. Data as at 31 December 2021. Sources: ourworldindata.org, worldobesity.org, Capital Group estimates

I also think that describing investments as “growth” or “value” can be limiting. There are many companies that move back and forth between the two brackets over their life cycles. Microsoft, for example, was considered a “value” stock more than a decade ago. But a change in top management saw the company alter direction and refocus resources into higher-growth services such as cloud computing and gaming. The company’s growth rate accelerated, and Microsoft was again perceived as a growth stock. The same also happens in reverse so rigid classifications such as value and growth might not be particularly useful to investors.

Steve Watson

Market pessimism creates buying opportunities

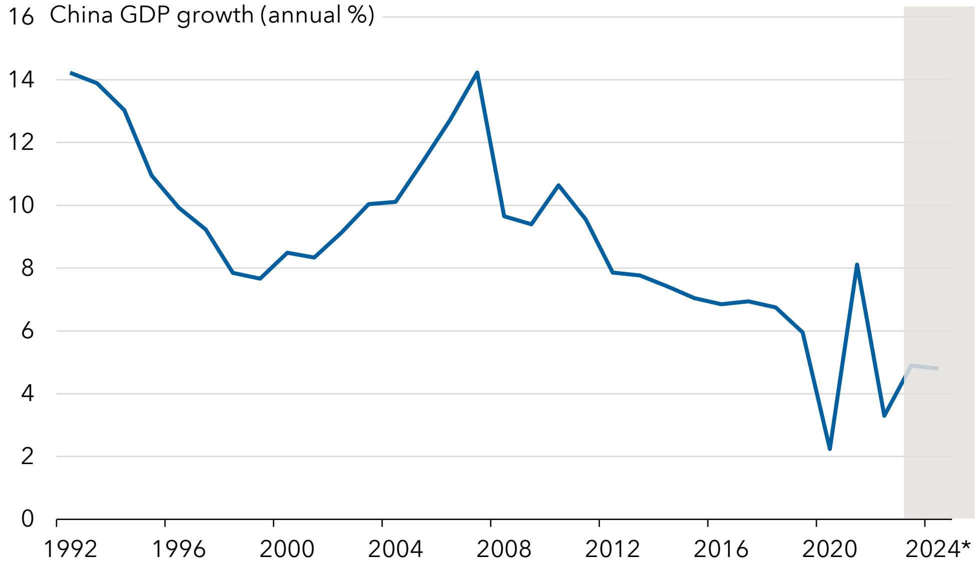
Steve: The world is undergoing a difficult transition, but it is a transition to a more normal environment, and I don’t see a reason for investors to be significantly alarmed. The monetary backdrop since the worst days of the Global Financial Crisis – low interest rates and low inflationary pressure – was the unusual part of the equation. All that liquidity was great for equity markets, in particular growth investments, and was vetted by technological change and the increasing penetration of internet-driven companies in our economy. But somewhat higher levels of inflation and interest rates are the normal if we look back the course of history and it is important for investors to start getting used to those conditions once again.

I am quite fully invested, which reflects how I feel about the markets going forward. Yes, there are worries about the state of the global economy with the US already in technical recession. There is also a high probability that Europe will follow suit because of inflationary pressure fuelled by high energy prices. We are seeing a lot of fear and uncertainties in the markets, but these situations can also generate investment opportunities. I believe investors should be confident about the long-term future of equity markets while remaining discerning about the investments they make today.

As a contrarian investor, I see interesting opportunities appearing across some of the more prosaic old-economy industries such as industrials (for example, construction equipment manufacturers and defence companies) and energy. The latter, however, isn’t confined to just renewable energy. It can also be companies focusing on smart systems for buildings to improve energy efficiency, companies that are developing carbon capture solutions or firms that are making inroads in battery technology. The list is long, but I am particularly interested in overlooked areas of the market that may also offer innovative products, services, or solutions.

One of those areas now is China, which has been the subject of a brutal selloff in 2022. While there are concerns over COVID-19 restrictions, the country’s property crisis and its economic outlook, we are seeing a lot of great companies in China whose shares are at all-time lows. A lot of Chinese companies not only offer innovation and earnings growth, but some are also paying out a decent proportion of their earnings as dividends, with the potential for these to rise even more in the future. The main areas of debate would be China’s COVID-19 policies and when (as well as to what extent) can the domestic economy return to growth. But recent shifts to lockdown restrictions on a more localised level signal a move in the right direction. It is important to watch for these changes at the margin as a precursor to policy relaxation and eventual reopening.

Can China return to growth?



As at 31 October 2022. Source: World Bank, Bloomberg. *Figures for 2022 onwards (the grey section in the chart) are estimates based on median forecasts from the October 2022 Bloomberg economist survey.

Harold La

Investing in innovation and change

Harold: I am a strong believer of innovation and how technology will continue to transform the world we live in. In recent years, there has been a tremendous amount of money being poured into energy transition and health care because people realise those are the areas that could solve many of our problems and make the world a better place. The universal desire to tackle climate change has seen billions of dollars being poured into the development of renewable energy and carbon capture solutions while health concerns have sparked the growth of COVID-19 vaccines and obesity drugs.

Another trend we are seeing in today's environment is how heightened volatility has accelerated the pace of change. We only need to rewind back to the start of the COVID-19 pandemic when many thought it would have been impossible for the health care industry to come up with an effective vaccine quickly. We managed to do it in one year. At the same time, we created a massive biologics contract development and manufacturing organization (CDMO) industry that could deliver billions of COVID-19 vaccine doses every year. Would this have been possible in a calmer period? Perhaps not.

On the topic of volatility, while investors are understandably concerned by the uncertainties we have been witnessing over the past few years, one lesson I learned from my investment career is that companies would eventually figure things out. Over the long-run, companies that survive would become more innovative and adaptable as they learn to deal with issues such as a higher cost of capital and sometimes irrational policymaking.

One area that I am interested in is Japan because many of the issues the global economy is facing now, the country has already dealt with in the past. Japan is an energy-poor country so Japanese companies are accustomed to high energy costs while the government has always focused on securing long-term contracts. Meanwhile, the country's shrinking workforce meant Japanese companies are used to dealing with human resource issues such as talent attraction/retention and incorporating working-from-home policies – something that many companies in the US or Europe are only starting to get to grips. It also wasn't too long ago that Japanese companies had to deal with a surging Yen. The currency is now trading at more moderate levels and if we coupled that with the country's high savings rate, the cost of capital for companies in Japan looks relatively cheap compared to the rest of the world.

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