INVESTMENT INSIGHTS

Market Perspective

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Peace, Freedom, and Profit Margins

Peace and freedom have been two foundational pieces in the development of the global economy in the post Cold War world as they fostered an unprecedented period of capital formation and technological innovation. The technology driven productivity gains kept inflation at bay as wage increases were moderate and the cost to produce goods could be managed lower. With inflation in check, interest rates were subdued providing a more attractive cost of capital along with lower hurdle rates for new investments. These factors combined to foster an environment where profit margins could expand and where globalization created new opportunities for revenue growth. Stock returns are driven by these two key factors, a company's ability to sell more stuff and to do it at a lower cost per unit. When these two ingredients are present, corporate profits rise and investors are willing to pay higher prices for the opportunity to participate in that growth as we have witnessed for some time now. The importance of margins can be seen when we consider that 55% of S&P 500 earnings for 2021 were driven by improving profitability.

Over the last few months, we have begun to see a shifting dynamic in the economy as Covid driven supply issues for both goods and labor have caused expectations for inflation to increase. This has pushed interest rates higher and the Federal Reserve has indicated their intention to raise short term rates in response. The impact of higher costs and interest rates is a reduction in profit margins. Investors have responded to the prospect for lower margins by taking some profits with the result being the ongoing correction we've seen which has been exacerbated by the Russian invasion of Ukraine this week. Given the underlying strength of the U.S. economy as evidenced by recent employment and industrial production reports, it is not likely that these margin pressures will lead to a protracted bear market in the near term, but they will present headwinds that could make it more challenging for stocks to resume their advance at the rate that we've become accustomed to over the last couple of years. It is reasonable to lower return expectations in an environment where we expect profit margins to moderate and investors should be careful to avoid more speculative holdings where the adjustment is likely to be much more severe. A great deal of this adjustment has been discounted in markets in recent weeks, but the extent of the impact will be determined by how aggressive the Fed response will be and by how long the rise in energy prices as a result of the Ukraine situation is sustained.

Covid supply issues are expected to moderate which should prove to be good news for investors near term as this process plays itself out. The impact of increasing global tensions is of some longer term concern particularly should it develop on a broader scale and be sustained for a lengthy period of time. Vietnam and the Cold War in the 1960s and 70s were a good example of this as demand from defense spending lead to inflation that was at times made more severe by government spending for Great Society programs and constrained energy supply as a result of Middle Eastern conflict. Higher interest rates accompanied rising inflation increasing cost of capital and greater industrial demand lead to an increase in commodity prices. Once again, lower margins and more modest stock returns were the result, but there is no reason to abandon stocks as a long term investment during a period like this because they are still likely to provide a decent inflation hedge. Should a similar environment present itself in the future, the expected increase in market volatility would present opportunities to add value via tactical adjustments in asset allocation strategy.

— Charles Mathews, CFA

Peace and freedom are critical to capital formation and innovation.

Sales growth and profit margins are the financial gauges that reflect the environment and drive stock returns.

The margin environment is shifting due to Covid driven inflation and the Ukraine situation.

Investors are adjusting expectations accordingly by taking some profits.

Covid driven supply issues will moderate to some degree with time.

Global conflict would create inflationary pressures that would negatively impact margins and present market headwinds.