The Transition from "Growth Abundance" to "Growth Scarcity" is Positive for Structural Growth Stocks

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There are increasing signs that economic growth is slowing from the high levels achieved during the cyclical recovery following COVID-19, with leading indicators suggesting further declines in growth over the next six to twelve months. A material economic slowdown should ensure that inflation returns to low levels over the short to medium term. However, the Federal Reserve is concerned that excessive demand for labour, due to a reduction in labour participation since COVID-19, would increase the probability of sustained high levels of wage inflation. Long run inflationary expectations have remained low for many years, but more recently have been increasing from a very low base, hence the need for central banks to act swiftly to lift short-term interest rates.

Central bank trade-offs

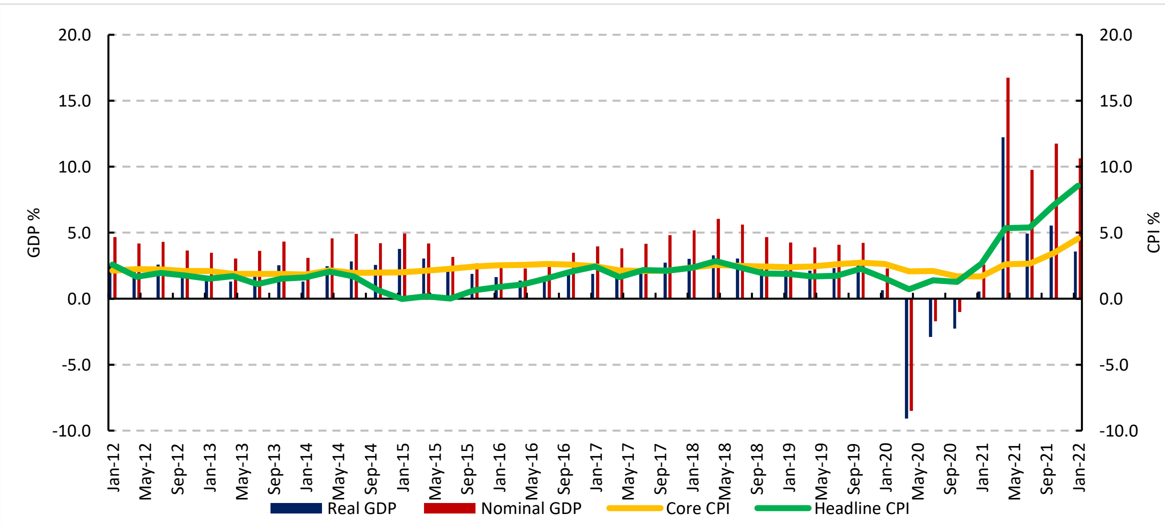
As central banks lift interest rates, the probability of a recession increases. Thus, central banks and governments face a trade-off between reducing inflation and increasing the likelihood of a recession. However, central banks and governments know that the cost of sustained high inflation is significantly higher than a cyclical recession. Therefore, we believe that the focus on inflation will remain the priority for central banks even as economic growth continues to slow.

A perfect storm for high quality, structural growth stocks

The last eight months have been a perfect storm for long duration, high quality growth stocks.

This perfect storm has been caused by an abundance of nominal GDP growth (including high levels of inflation) that has resulted in asset allocators indiscriminately selling growth stocks and buying value and cyclical stocks.

Figure 1: Nominal GDP Growth over the Past Decade



Source: Federal Reserve Economic Data. Data published April 2022.

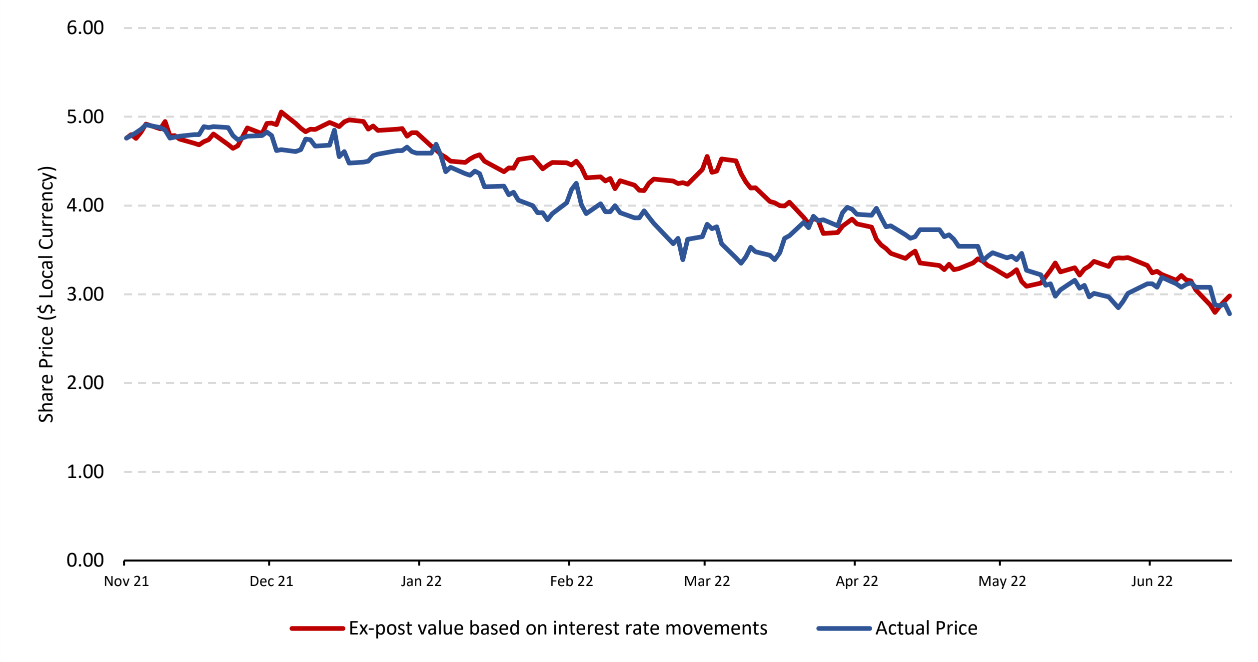
A by-product of this recent high inflation and strong economic growth has been a substantial increase in long-term bond yields from low levels. Over the past six months, the 10-year U.S. Treasury yield has increased from 1.46% to 3.26% and the 30-year U.S. Treasury yield has increased from 1.86% to 3.33%. When long-term bond yields increase significantly over a short time period, this adversely impacts the market value of long duration assets including high quality, structural growth shares that Hyperion invests in. This is because long duration assets are more sensitive to changes in discount rates.

Figure 2: U.S. 10-year Treasury Securities

Source: Federal Reserve Bank of St Louis (2022) 10-year Treasury Constant Maturity Rate in Percent (Not Seasonally Adjusted). Data as at 6th May 2022.

The negative impact of the recent increase in long-term U.S. Treasury yields on long duration assets, such as Hyperion's Global portfolio (ASX: HYGG), can be seen in Figure 3. We call this the duration impact. It is important to realise that the duration impact only holds over short time periods. The strong underlying growth in earnings per share (EPS) of Hyperion's portfolios over multi-year periods should more than offset the negative short-term valuation influence from higher bond yields and lower price-to-earnings (P/E) ratios.

Figure 3: Historical Simulated Effect of Interest Rate Movements on Value Using Duration



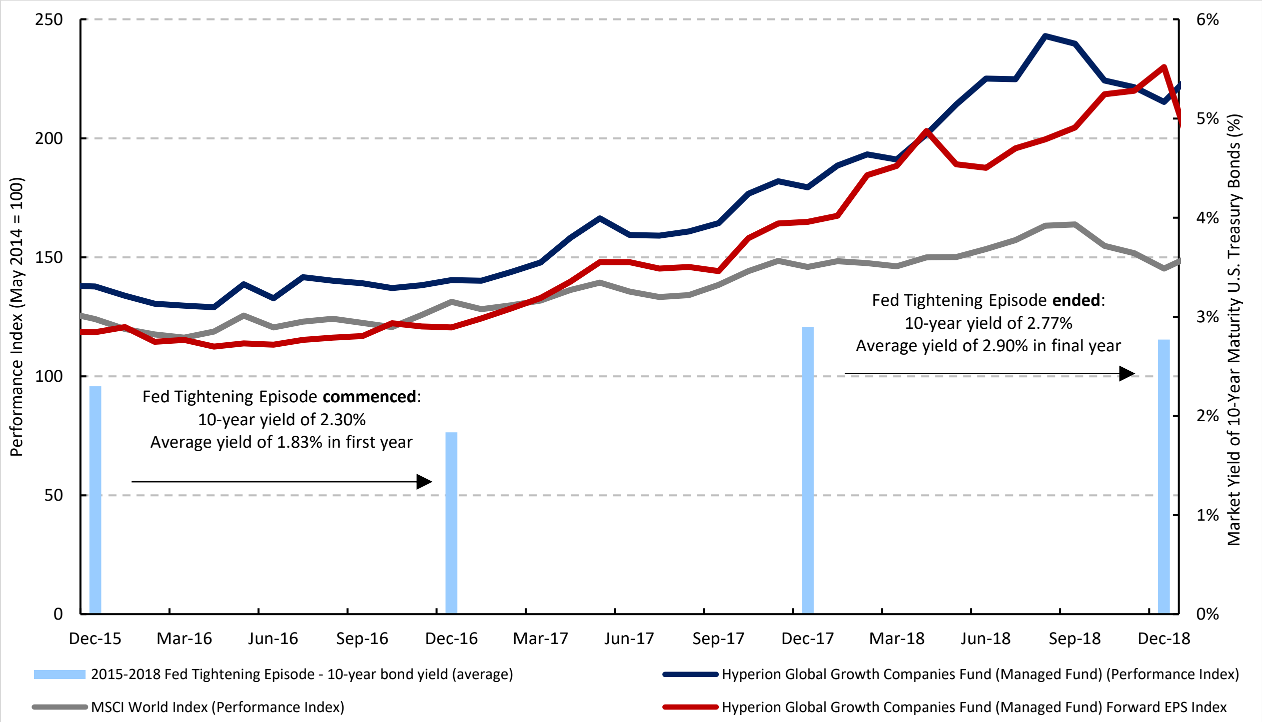
Source: FactSet, Hyperion.

Time is the friend of high-quality structural growth investors

Over longer time periods, the double-digit EPS growth of our portfolios should outweigh the negative duration impact of higher long-term bond yields. This is because earnings growth is time based and it compounds. The longer the time, the more impact earnings growth has on the value of the portfolio.

We experienced a material increase in long-term government bond yields during the period from 2015 to 2018 (refer Figure 4) but because the increase was spread over multiple years, the duration impact was more than offset by the influence of strong EPS growth on the market value of the portfolio.

Figure 4: 2015-2018 Fed Tightening Cycle



Source: Hyperion, MSCI.

The recent underperformance is macro driven and does not reflect long-term underlying fundamentals

Macro factors tend to dominate the short-term performance of our portfolios. As a result, alpha generation is not linear, particularly over short time periods.

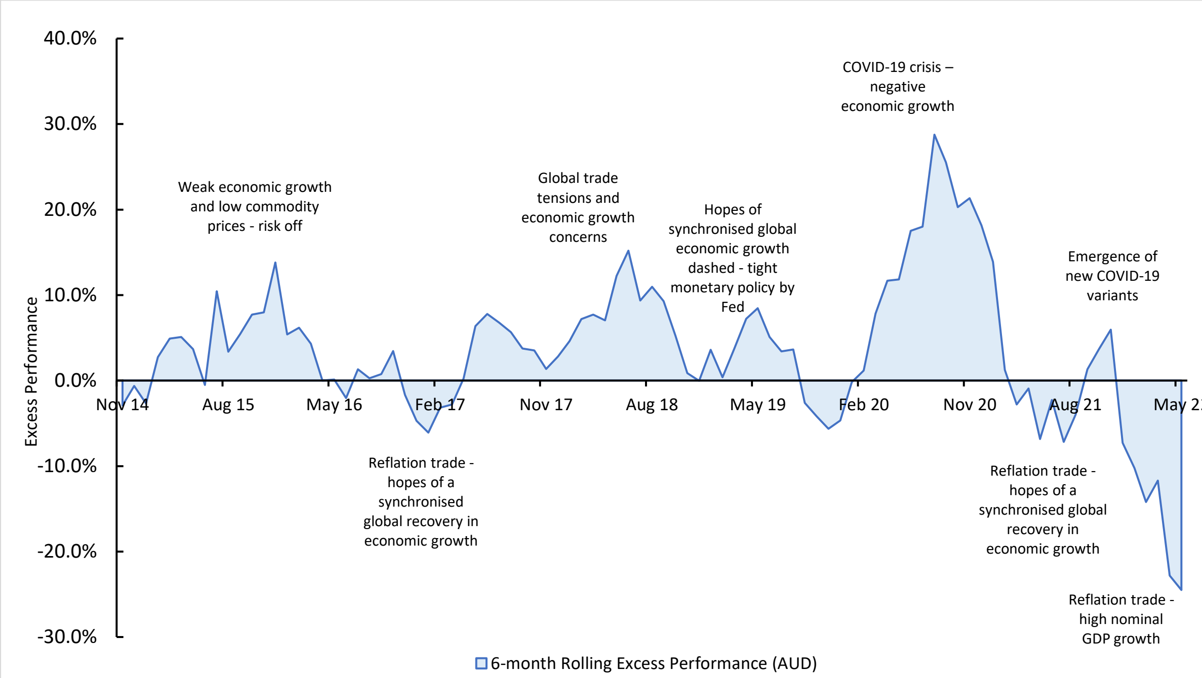
In contrast, over long time periods, it is the compounding effect of double-digit EPS growth that dominates portfolio performance.

Figures 5 and 6 illustrate the strong short run macro influence on alpha generation. Hyperion's short-term alpha generation tends to be heavily influenced by changes in economic expectations and associated bond yield movements and thus follows a cyclical wave pattern with alpha clustered in certain periods.

The key macro factors that dominate short-term alpha generation are nominal GDP growth levels (and the associated trends in corporate profits) and material changes in long-term bond yields over short time periods. Hyperion's portfolios tend to be less sensitive to the expected level of economic activity but more sensitive to changes in bond yields relative to the overall market.

During periods of strong nominal GDP growth there is an abundance of profit growth and lower quality, cyclical stocks benefit relatively more than structural growth stocks. At the same time, high nominal GDP growth (particularly when there is high inflation) tends to result in higher yields on government bonds. These high growth or reflationary environments tend to be associated with short-term negative alpha generation.

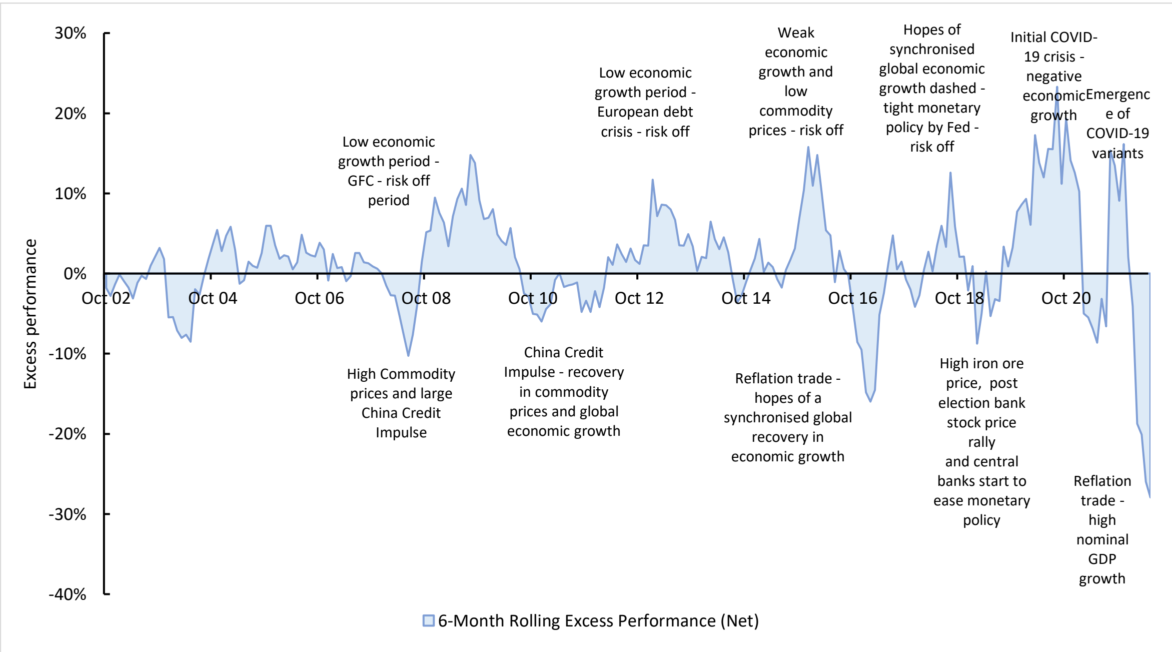
Figure 5: Hyperion Global Growth Companies Fund (Managed Fund)* Rolling Six-Month Alpha



Source: FactSet, Hyperion. Data as at 31st May 2022.

* Hyperion Global Growth Companies Fund (Managed Fund) inception date 1st June 2014. The Hyperion Global Growth Companies Fund (Managed Fund) changed its name from the Hyperion Global Growth Companies Fund – Class B on 5 February 2021 in order to facilitate quotation of the fund on the ASX.

Figure 6: Hyperion Australian Growth Companies Fund Rolling Six-Month Alpha



Source: FactSet, Hyperion. Data as at 31st May 2022.

Long-term fundamentals and valuations remain stable for our portfolios

We do not believe the recent drawdown represents a permanent loss of capital because it has not been driven by a deterioration in the long-term fundamentals of the businesses in our portfolios. We estimate that the long-term valuations of our portfolios have been steady to rising over the past year. Recent reporting season results have been broadly consistent and supportive of our long run valuations and expected future returns.

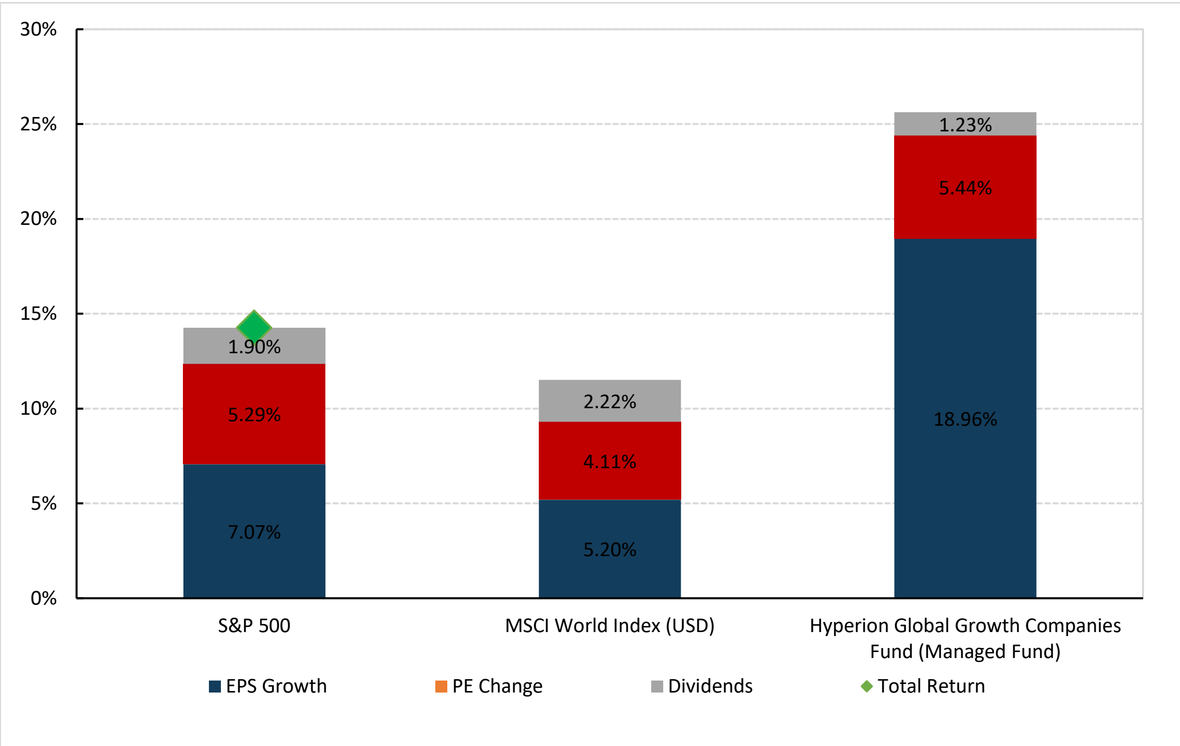
The duration impact from increasing bond yields and associated lower P/E ratios is only short-term in nature given the underlying pricing power of the companies in our portfolios. That is, the portfolio companies have the pricing power to ensure that future free cash flows are maintained in real (after inflation) terms. This significant pricing power and the ability to maintain future free cash flows in real terms should enable the portfolios to enjoy a recovery in P/E ratios over time even if inflation remains high in the long term.

The recent negative duration impact as reflected in lower short-term valuation metrics has a one-off, non-compounding impact that amortises over time.

Bond yields and P/E ratios are range bound and mean reverting and thus their influence in one period tends to reverse in future periods.

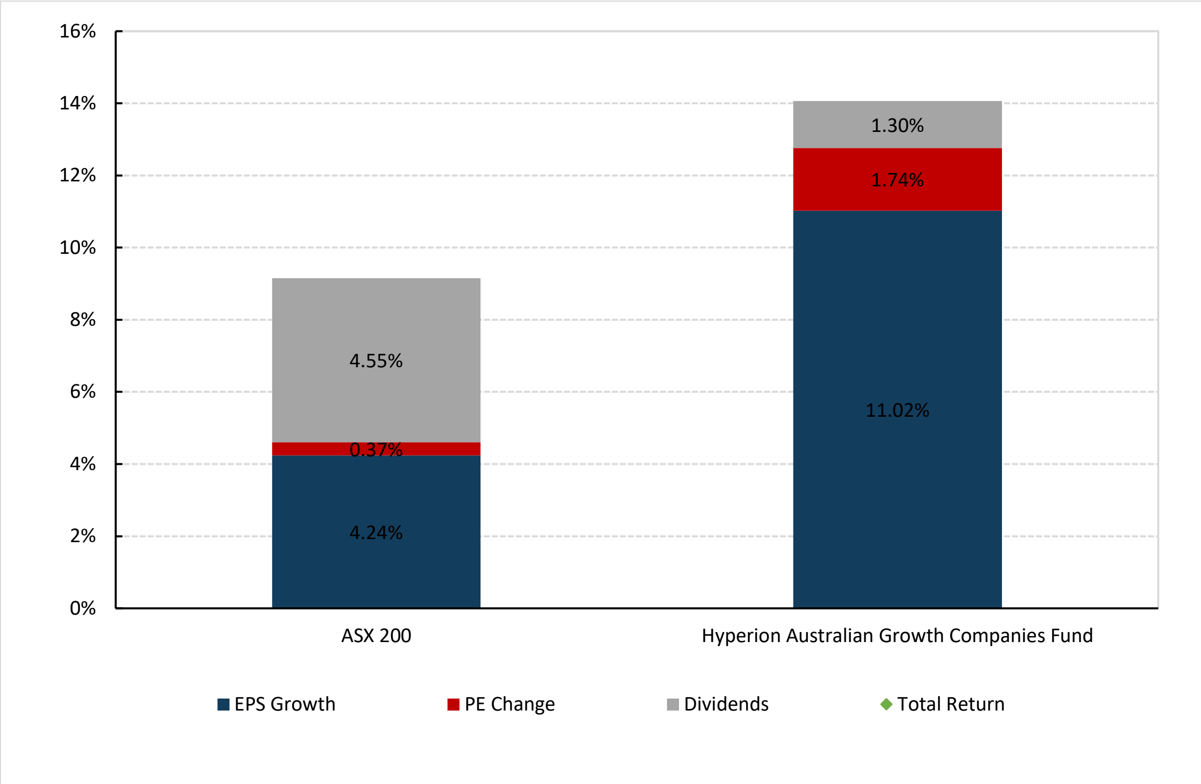
However, the largest driver of likely future performance is the underlying compounding of double-digit (real or inflation adjusted) EPS growth over the long term (refer Figures 7 and 8).

Figure 7: Earnings Per Share Growth is the Driver of Stock Returns



Source: Hyperion, FactSet. Total gross return presented as price return in local currency. Past performance is not indicative of future results. Data series: December 2014 – December 2021.

Figure 8: Earnings Per Share Growth is the Driver of Stock Returns



Source: Hyperion, FactSet. Total gross return presented as price return in local currency. Past performance is not indicative of future results. Hyperion Australian Growth Companies Fund inception date: 30th September 2002. Data series: December 2003 to December 2021.

The macro and style headwinds appear to be ending

There are increasing signs that the short-term macro factors that have driven long duration growth stocks lower and caused their relative underperformance appear likely to be approaching an end.

It is likely that lower economic growth and lower inflation would create a growth scarcity environment that would be supportive of our investment style. In addition, as time moves forward the compounding impact of superior EPS growth of our portfolios relative to the market EPS growth will help support alpha generation over the long-term.

We think the following key factors will likely drive a slowdown in economic growth:

- The absence of large government spending programs that were common during the COVID-19 crisis;
- High debt levels;
- Low savings rates in the U.S.;
- Negative real wages growth in most countries;
- Higher short and long-term interest rates;
- Excess inventories held by major retailers like Walmart and Target;
- High oil, gas and food prices forcing consumers and businesses to cut back on other expenditures;

- Low levels of consumer confidence;
- Declining manufacturing and service PMIs;
- Negative wealth effects from lower stock, bond, and other long duration asset prices;
- Slowing housing activity;
- The Federal Reserve Bank of Atlanta's "GDPNow" estimate for the June quarter 2022 is indicating zero real economic growth; and
- A slowing in employment growth with news flow regarding job losses increasing.

The Federal Reserve is building credibility regarding price stability

Central banks have been taking steps to ensure that inflation returns to low levels over the next year with the Federal Reserve increasing official interest rates by 75bps recently and creating expectations that they will continue to raise rates until there is "clear and convincing" evidence that inflation is abating.

This large increase in official interest rates is positive for the Federal Reserve's credibility in terms of ensuring price stability. This action gives us increased confidence that the Federal Reserve and other central banks are serious about regaining price stability as quickly as possible.

The sooner the Federal Reserve can bring inflation to lower levels the less severe any resulting economic downturn is likely to be. The higher that inflation expectations get and the longer they exist, the greater the probability that they will become entrenched in the economy. We continue to believe that an economic soft landing or a mild "technical" recession is most likely, given that long run inflationary expectations remain relatively low.

We remain confident that the Federal Reserve will bring down inflation

We continue to believe that the Federal Reserve and other central banks in developed economies will be successful in bringing down inflation.

We are confident that inflation will come down because high inflation adversely impacts most people in the economy. Sustained high inflation penalises most wage earners, particularly low-income earners, in the form of negative real wage growth. It also creates unnecessary pricing complexity for businesses, wage spirals, and high levels of uncertainty and unnecessary stress for most people in an economy.

High inflation is negative for bond holders, particularly owners of long duration bonds. Long duration bonds are adversely impacted by high inflation because the future interest and principal repayments are made in fixed nominal values that are not adjusted for inflation.

High inflation is negative for governments and central banks because it reduces confidence in their ability to manage the economy and erodes confidence in the currency as a store of value. High sustained inflation normally results in governments becoming extremely unpopular and being removed from office.

High inflation is only a short-term negative for high quality, structural growth stocks

The change to high inflation from low inflation is initially a significant negative driver for the prices of high quality, structural growth stocks because these stocks act like long-term bonds over the short term. In the long term, inflation is neutral for high quality, structural growth stocks because most of these businesses have strong pricing power that enables them to maintain their future free cash flows in inflation adjusted terms.

Additionally, over long time periods, the compounding impact of double-digit EPS growth dominates any short-term impact from lower P/E ratios.

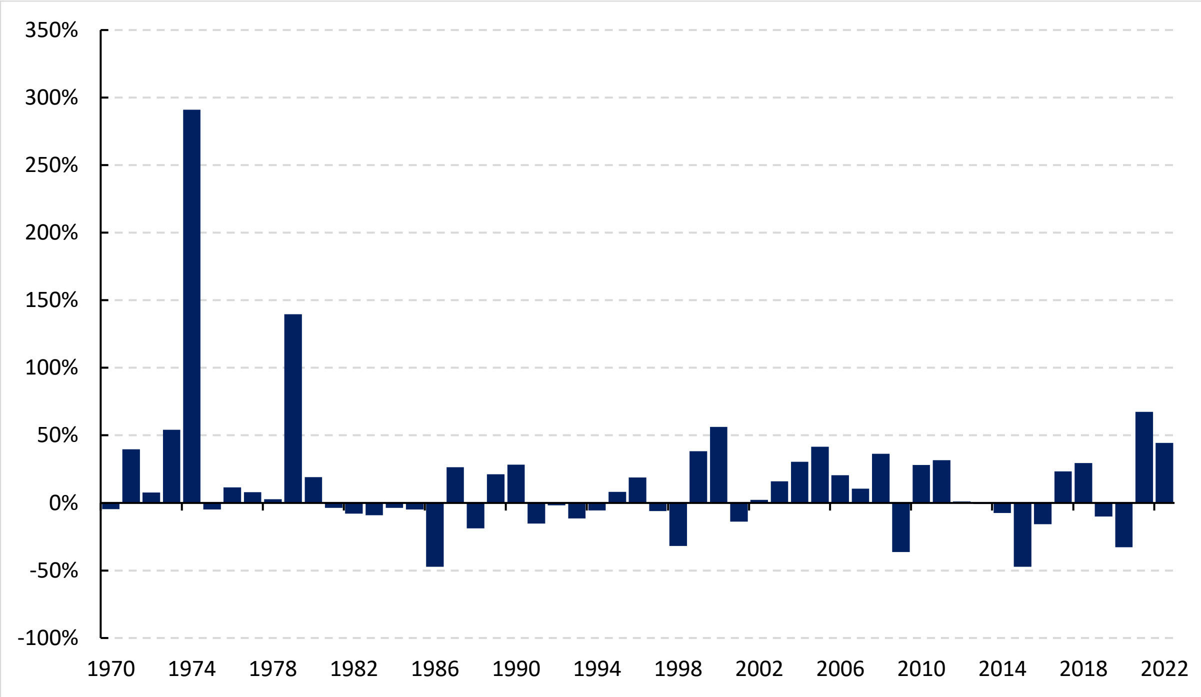
The economic environment today is significantly different to high inflation environments of the past

High inflation has not been part of most large, developed economies for several decades. In fact, sustained high inflation is traditionally associated with poorly managed third world countries with high levels of corruption.

The last time that large, developed economies experienced a sustained period of high inflation was during the 1970s. We think it is unlikely that the sustained high inflation experienced during the 1970s will be repeated for the following reasons:

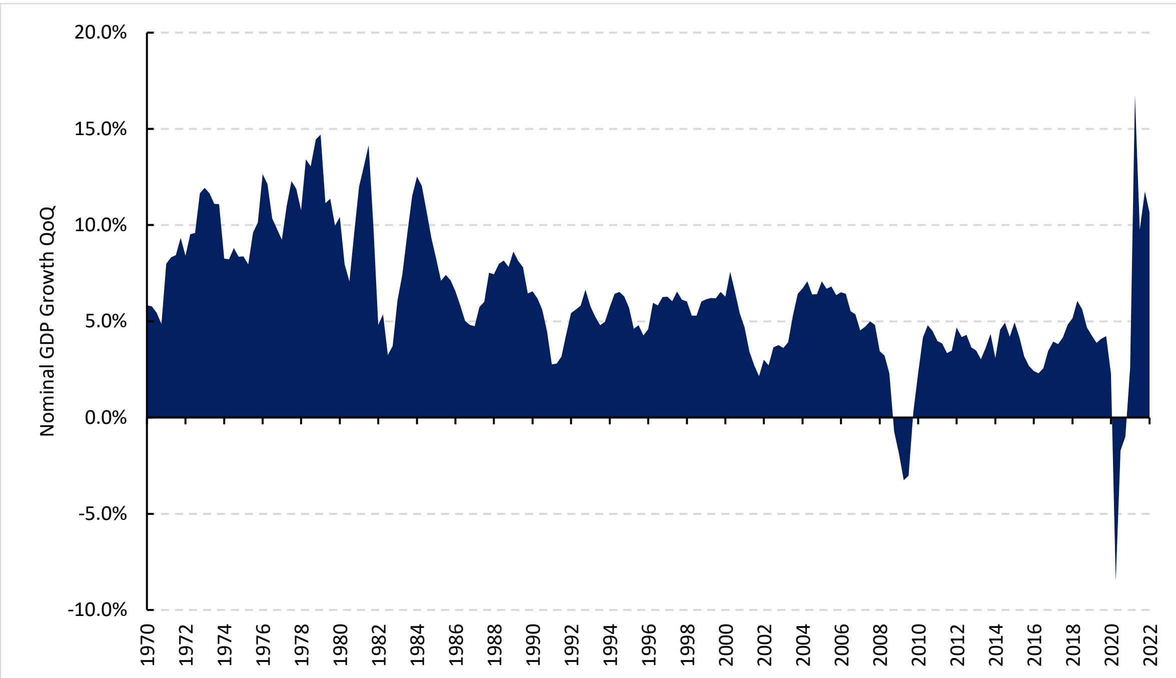
1) Low inflationary expectations over the long-term remain entrenched today. This was not the case in the 1970s.
2) Underlying economic growth is much weaker today than in the 1970s in most major economies. Real U.S. economic growth averaged 3.3% in the 1970s compared with a trend growth rate of half that today. This is because the demographics have changed from young and growing populations and a robust middle class with very low debt levels in the 1970s to the opposite today.
3) The Federal Reserve in the 1970s allowed inflation to remain at high levels for many years and this greatly reduced its inflation fighting credibility.
4) Unions and organised labour represent a much smaller percentage of the workforce today compared with the 1970s.
5) Nixon removed the gold standard and effectively devalued the USD in the early 1970s. This was inflationary. In contrast the USD has been increasing in value recently.
6) During the 1970s there were two separate oil crises and in each case the percentage increase in the oil price was significantly higher than in recent times. In addition, the oil intensity of the economy was much higher during the 1970s compared with today.
7) The influence of software-based technology and robotics was much lower and narrower in the 1970s compared with today and thus the deflationary impact of innovation was reduced.
8) Debt levels were relatively low in the 1970s compared with today. Thus, there was not the debt burden that hangs over society that is apparent today. Also, the productivity of debt was significantly higher in the 1970s.

Figure 9: Oil Price Change (YoY)



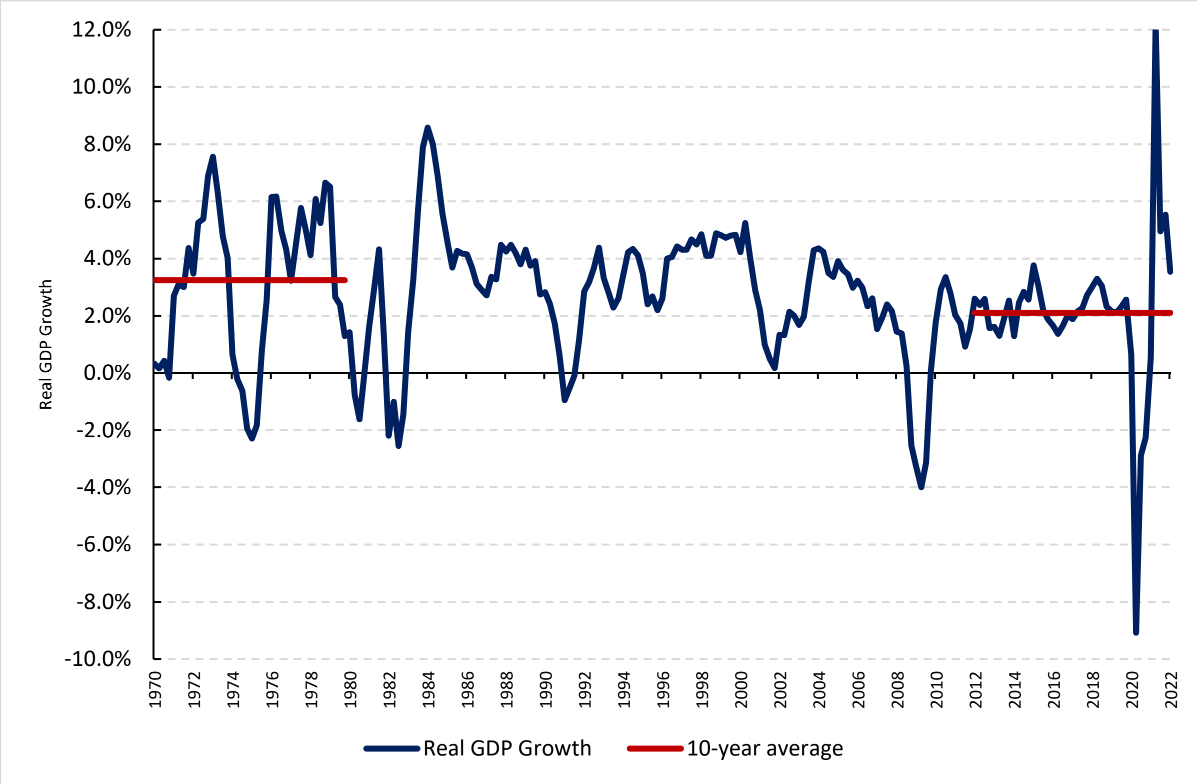
Source: World Bank, Statista. Data from 1970 to 2021 is an average price across Brent, WTI, and Dubai crude. Data for 2022 is year to date capturing data up to 30th April 2022 with price average from selected OPEC crude oils.

Figure 10: U.S. Nominal GDP Growth (QoQ)



Source: Federal Reserve Bank of St Louis (2022).

Figure 11: U.S. Real GDP Growth - 1970s compared to the last 10 years (QoQ)



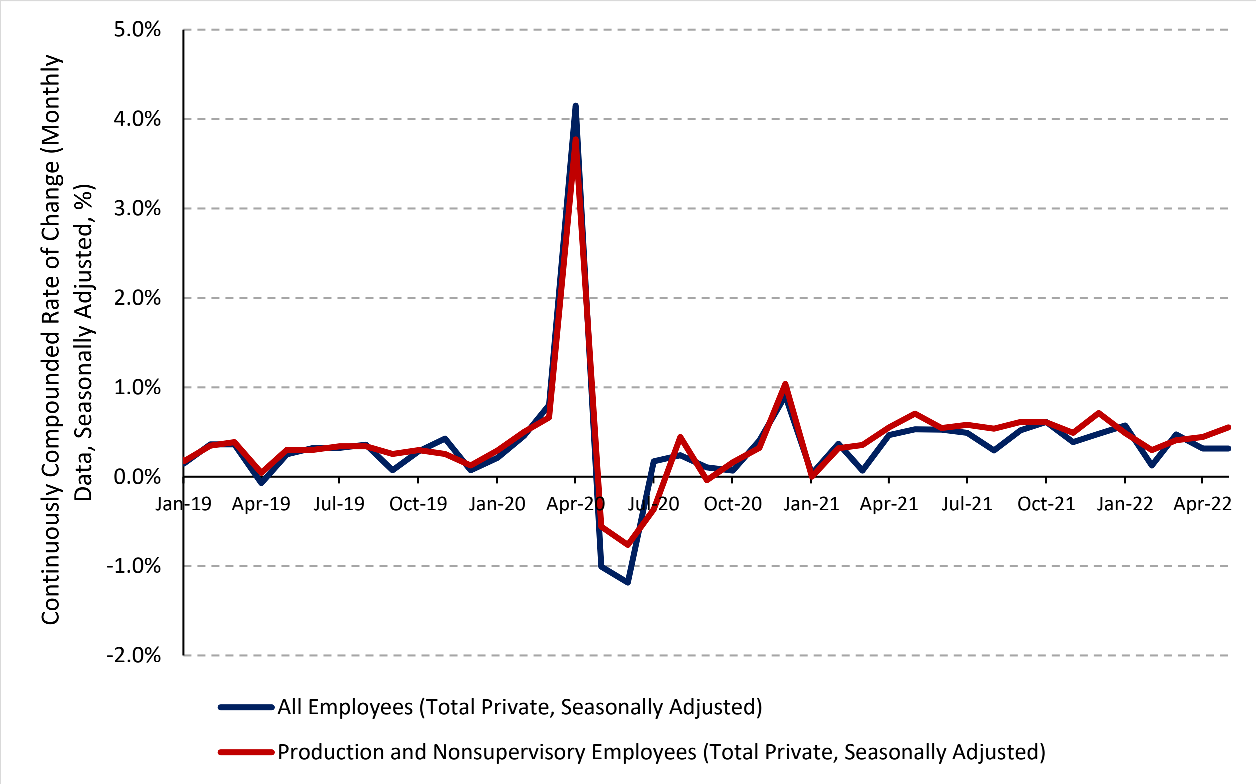
Source: Federal Reserve Bank of St Louis (2022).

Is excessive wage growth likely to create an inflationary spiral?

We think that a wages spiral is unlikely given the slowing activity in the global economy and the low levels of influence that unions exert in most major economies.

U.S. wages growth has been reasonably stable over the past year. As the economy continues to slow and unemployment levels start to climb, we expect wages growth pressures to moderate.

Figure 12: Average Hourly Earnings of All Employees and Production and Nonsupervisory Employees – Continuously Compounded Rate of Change



Source: Federal Reserve Bank of St Louis (2022) Average Hourly Earnings of All Employees and Production and Nonsupervisory Employees (Total Private, Dollars per Hour, Monthly, Seasonally Adjusted). Chart depicts Continuously Compounded Rate of Change (Monthly).

Economic contraction will favour high quality structural growth stocks

Lower levels of nominal GDP growth will remove the incentive for capital allocators to switch from high quality structural growth stocks to lower quality value and cyclical stocks. In fact, a material economic slowdown should force capital allocators to reverse the style-based trading strategies they have employed over the past year. This would involve them switching back to high quality structural growth stocks and away from lower quality value style stocks that are highly sensitive to and reliant on economic expansion for their growth. This will reduce the selling pressure and boost the buying support for the stocks in Hyperion's portfolios, at least in a relative sense.

Also, lower expectations for nominal GDP growth should result in a reversal of the recent trend to higher long-term bond yields. This will remove the pressure on long duration stocks like the ones in our portfolios and provide a tailwind if long-term bond yields decline materially from current levels.

Key factors required to sustain high inflation: high long-term inflationary expectations and a lack of credibility of the Federal Reserve

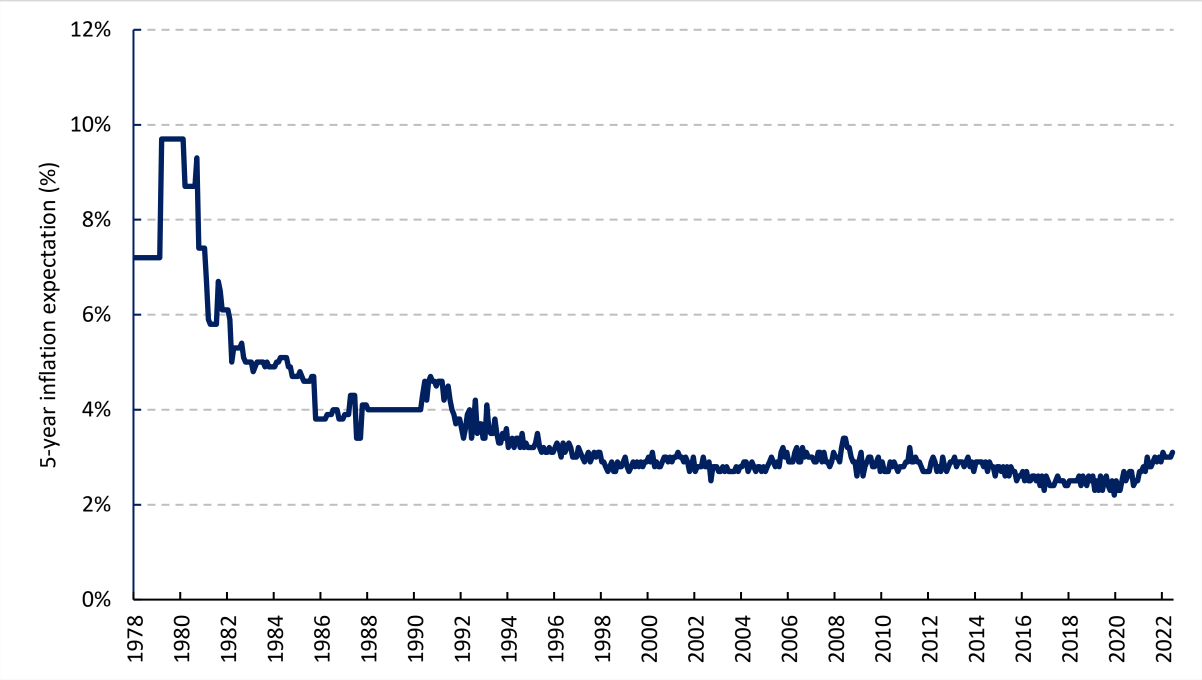
Long-term inflationary expectations are key to whether inflation remains high or returns to low levels.

Current long-term inflationary expectations remain significantly lower compared with the very high inflationary expectations in the late 1970s and early 1980s. However, it should be noted that long run inflationary expectations have been moving higher over the past year from very low levels. The latest reading for June 2022 has long run inflationary expectations at 3.1% which remains acceptable provided it does not continue to climb significantly from current levels.

The lower long-run inflationary expectations we have currently should make the job of the Federal Reserve easier relative to the late 1970s and early 1980s and this should reduce the probability of a severe recession resulting from tighter monetary policies being implemented.

The other factor that will help return inflation to lower levels is that the Federal Reserve has greater credibility than when Paul Volcker took over as Chair in the late 1970s. Volcker had to build credibility because of the poor reputation that the Federal Reserve suffered from after allowing high inflation to continue for most of the 1970s. Federal Reserve credibility in terms of ensuring price stability is key to minimising the risk of a deep, long-lasting recession.

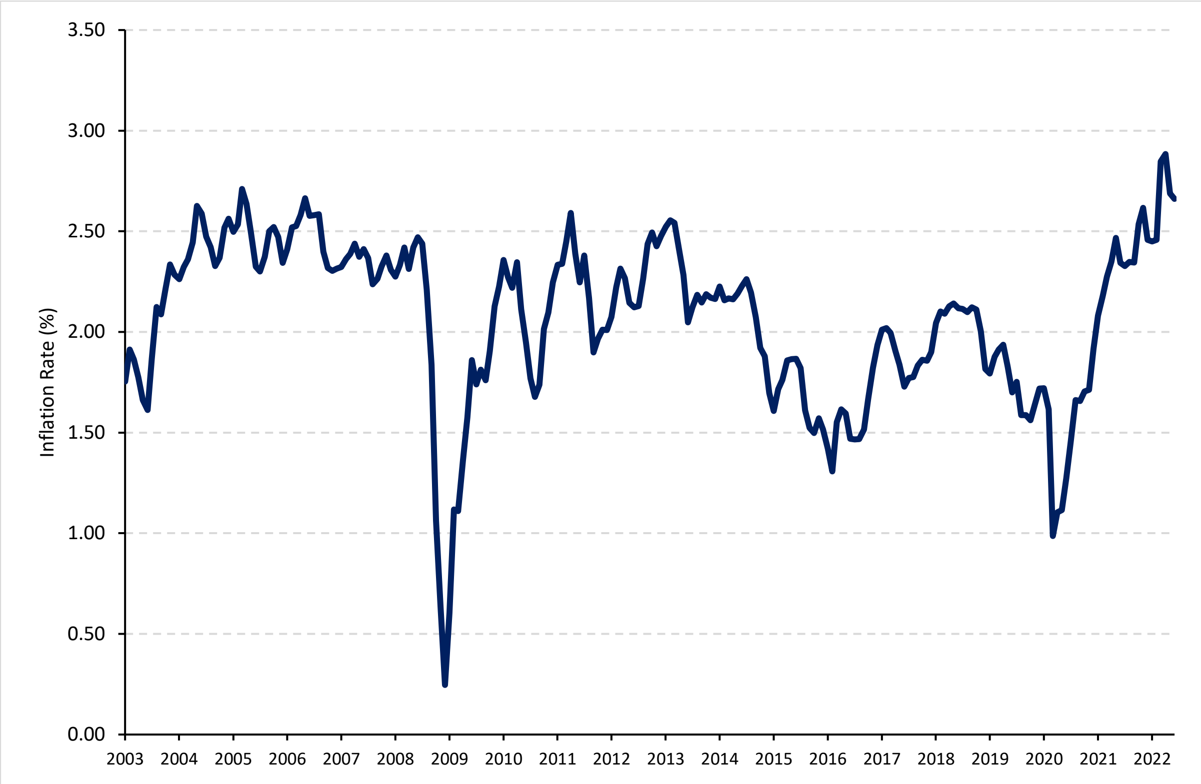
Figure 13: University of Michigan Consumer Survey – 5-year Inflationary Expectations



Source: University of Michigan (2022).

The 10-year breakeven inflation rate serves as an indicator of the market's inflation expectations over a 10-year horizon. It is calculated as the difference between the U.S. 10-year Treasury securities yield and the Treasury Inflation-Protected Securities (TIPS) yield. Figure 14 shows that long run inflation expectations remain at reasonably low levels. At the time of writing, the implied 10-year inflation rate was 2.55%.

Figure 14: 10-year Breakeven Inflation Rate - Not Seasonally Adjusted



Source: Federal Reserve Bank of St Louis (2022) 10-year Breakeven Inflation Rate (Monthly, Not Seasonally Adjusted).

A soft landing or a shallow recession remain the most likely outcomes

We believe a soft landing, or a shallow recession are the most likely outcomes over the next year.

Either case would be more favourable to Hyperion's style of investing compared with the high growth and high inflation environment that we have been facing over the past 12 months.

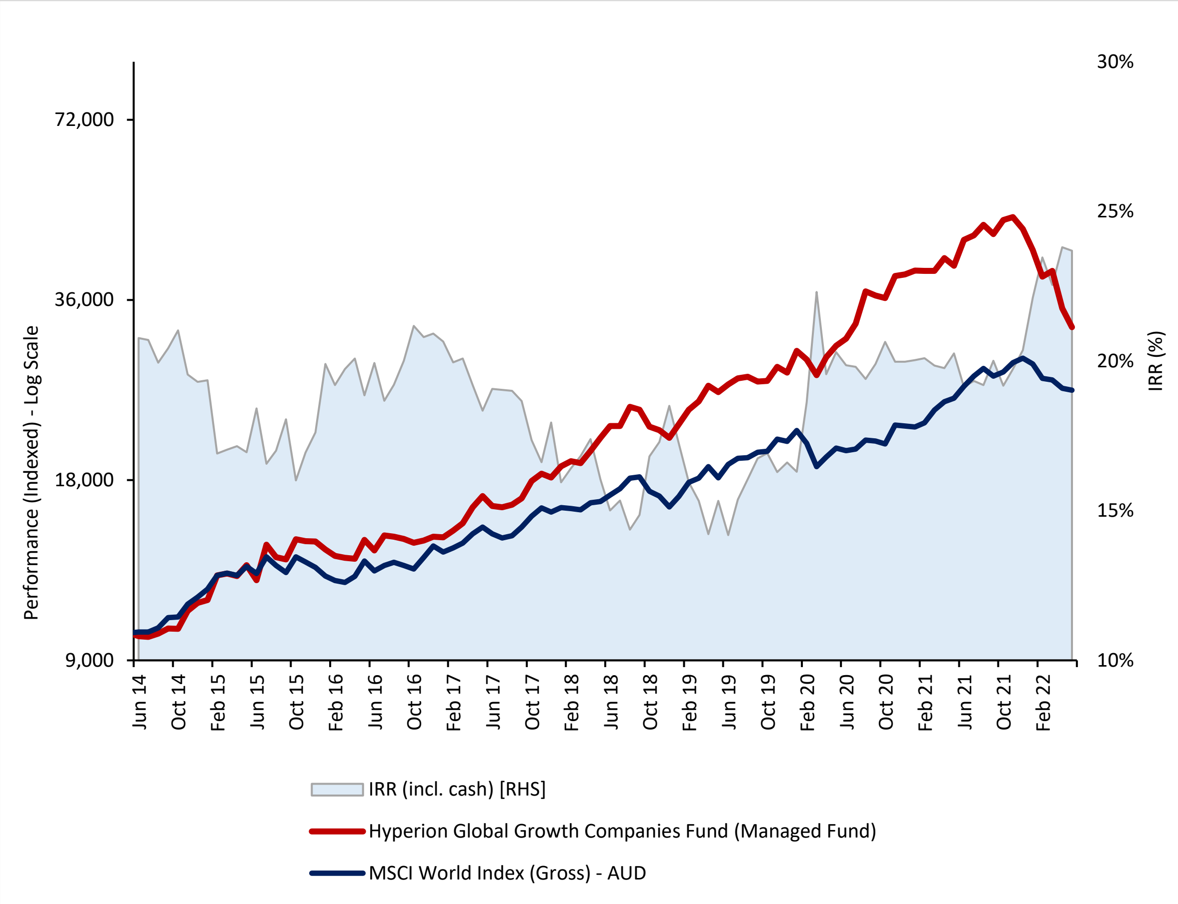
Our companies tend to be less sensitive to levels and trends of economic activity than most listed stocks. The companies in our portfolios grow primarily by taking market share, whereas most stocks in the major indices are sensitive to economic activity and only grow their revenues and profits when the economic pie is expanding.

In contrast, our companies have strong value propositions and large addressable markets that enable them to grow their revenues and free cash flows at double-digit rates even when economic activity is weak.

If there is a severe economic recession, then most listed businesses will suffer material negative revenue growth and even more material negative EPS growth. In a severe recession, we would expect our portfolios' revenues and EPS growth to slow but not nearly as much as the rest of the market.

The forecast long-term returns (IRRs)[1] of our portfolios have increased as share prices have fallen, and the long-term estimated underlying valuations have remained stable. The forecast 10-year IRRs for the portfolios have become elevated in recent months compared with their historical levels.

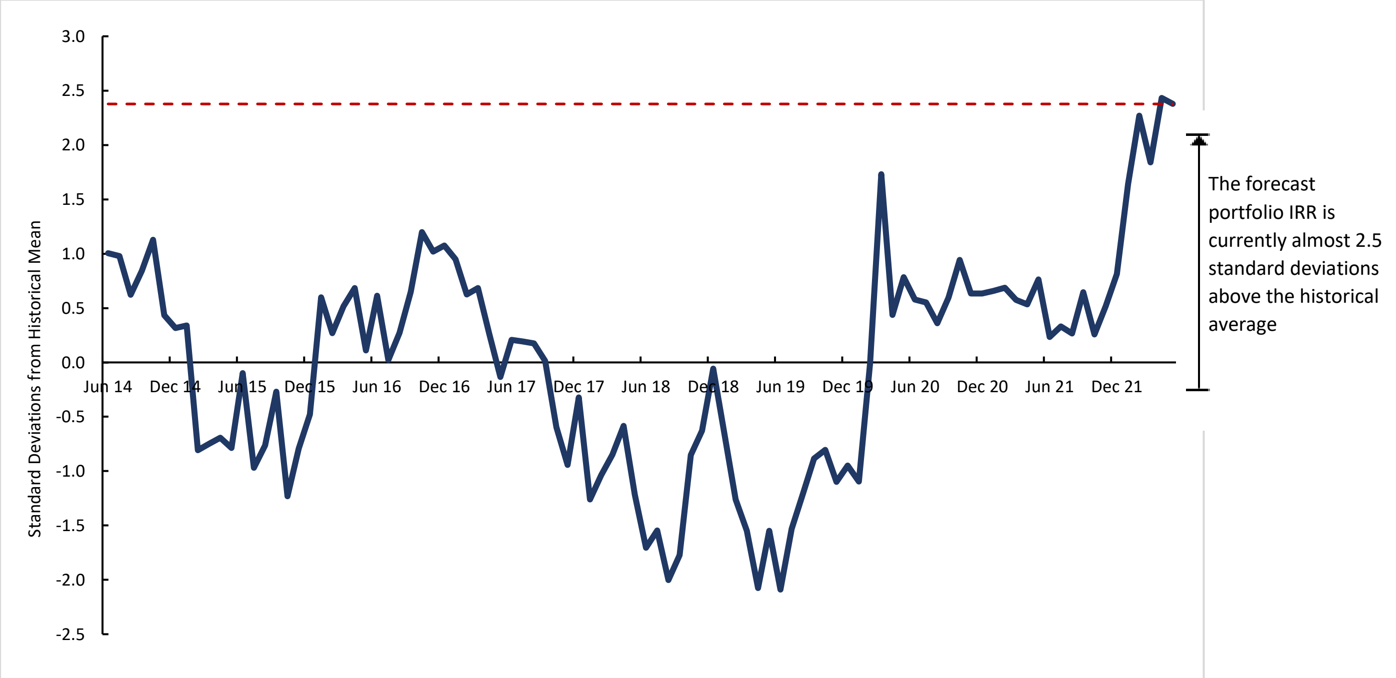
Figure 15: Hyperion Global Growth Companies Fund (Managed Fund) Performance and IRR



Source: FactSet, Hyperion. Data as at 31st May 2022.

[1] Internal Rate of Return (IRR)

Figure 16: Forecast (Ex-ante) Portfolio IRR relative to Historical Average



Source: FactSet, Hyperion. Data as at 31st May 2022.

Conclusion

We think it is the rapid change in long-term bond yields, particularly over the past six months, that has been the primary cause of the decline in the market value of our portfolios. The underlying EPS growth of our portfolios has not been able to offset the valuation impact from lower P/E ratios due to this rapid change. This is because EPS growth is time dependent whereas bond yield and P/E ratio changes are not time constrained. Over longer time periods, EPS growth will dominate valuations, but large changes in bond yields over short time periods can overwhelm the impact of EPS growth.

Despite recent declines in our portfolios, the underlying fundamentals have not deteriorated. We think the competitive positions and long-term earnings growth profiles of our portfolios remain strong.

If the change in the bond yield occurred over a longer period of time, then the underlying increase in EPS and implied increase in the intrinsic values of our portfolios would have been able to more effectively counteract the impact of higher bond yields.

We believe the economic environment for our style of investing should improve over the next 12 months.

Low levels of nominal economic growth, including low inflation, remains the most probable long-run economic framework. We continue to believe that technology-based innovation will be a major structural deflationary force in the long run.

Mark Arnold (CIO) and Jason Orthman (Deputy CIO)

June 2022

To hear more, watch our webinar “Pricing Power, Macro and Short-termism” on-demand to hear Hyperion Asset Management’s Managing Director and CIO Mark Arnold, and Deputy CIO Jason Orthman discuss the macroeconomic outlook and if the structural headwinds still remain; pricing power of Hyperion’s portfolios both domestically and globally; how this short-term fear versus long-term compounding has been playing out; and why there is opportunity in structural growth.

(Watch the webinar on-demand)

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Past performance is not a reliable indicator of future performance.

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