BALLAST
ASSET MANAGEMENT

Positioning for Higher Inflation and Rising Rates

Are allocators over-exposed to duration? We believe the answer for most is a resounding "Yes" – both in equity and fixed income exposure. Here's the deal; we have been in a unique environment for over a decade that has rewarded long-duration. That environment had four important characteristics – incredibly low interest rates, low inflation, extraordinary Fed liquidity, and anemic economic growth. Why do those characteristics encourage long-duration investments? Because the discount rate applied to each is low. Whether it's a 30-year bond, or equity in a company that is growing revenue at a fast clip (regardless of whether it makes money today), investors were rewarded being overweight in those segments because the four characteristics above encouraged it. All four of those characteristics have changed or are changing, and at least three (**Interest Rates, Inflation, and Fed Liquidity**) are likely to be very different in the years ahead. While the rate of economic growth is increasingly uncertain, we remain constructive on the US for several reasons which we will get into below. We believe there is significant risk to over allocations to long-duration bonds and equities in that environment and think that we are in for a multi-year shift to shorter duration assets (short-duration fixed income, high cash flow/low multiple equities).

Interest Rates

The lower interest rates are, the lower the Discount Rate we apply to future cash flows. While the math for calculating that discount rate is different for bonds versus equities, directionally higher rates affect both asset classes in a similar manner. Take a 30-year US Treasury Bond, which today pays roughly 2¼%. Most investors understand that if interest rates go up, the value of bonds goes down. That occurs not only because of the preference for the higher rate you can get on new bond issuances at higher coupons, but also because the rate you discount the payout when the bond matures is worth less. Same for equities – when interest rates go up, the discount rate applied to the cash flow stream goes up. Therefore, those cash flows in the future are less valuable. That is especially true when applying that discount rate way out in the future to the terminal value (i.e., like when the long-duration bond matures).

Inflation

Obviously, inflation is running hot at the moment, and has for the last year or so. We believe inflation will remain above the average we experienced over the last decade for three primary reasons:

1) Higher energy prices as we transition to renewable energy

2) Restarting the economy and sorting out global supply chain issues

3) The circular nature of higher wages and those costs being pushed through to consumers

Inflation is very negative for bonds with fixed interest rates given the future coupon payments remain the same even as the value of those payments falls. In addition, the value of the principal falls in-line with inflation. Inflation negatively affects the future cash flows of companies, unless they are able to pass all of the inflationary impact on to their customers. Even then, high inflation should serve as a tailwind to higher interest rates, which again is bad for long-duration equities.

Fed Liquidity

The Federal Reserve Bank in the US has been extraordinarily accommodative over the last decade, and in particular; over the last couple years. One can argue when they should or should not have been, but the point is, that is about to change dramatically. As the Fed begins to shrink their balance sheet, it has two distinct effects. First, it directly reduces liquidity through a lower money supply (M2). Second, it reduces the demand for new treasury bond issuances, which on the margin, pressures the interest rate on those new issuances higher. We believe this liquidity was in no small part the reason for several of the high-flyer tech stocks and MEME stocks performing the way they did over the last couple years. The reverse is also likely to be true.

Economic Growth

Clearly the events in the Ukraine and the subsequent effect that is having on commodity prices introduces increased risk to the economic outlook. As we sit here today, the economy remains strong, demand is elevated, wages are keeping up with inflation and inventory remains low. Assuming we get a similar supply response to high commodity prices that we have in the past, that could get sorted out, leaving the economy relatively unscathed. Admittedly, that is a real risk. That said, based on conversations with the management teams of our companies, demand remains resilient, and fundamentals continue to improve. If we get economic growth over the next five years above what we saw most of the last business cycle, we believe that will provide more fuel to the fire of transitioning from long to short-duration assets.

Conclusion

So, what does all this mean? We believe what worked over the last business cycle is unlikely to work this cycle. We are likely to see an extended transition from long-duration assets to shorter duration assets, and we think most allocators are not yet positioned for that transition. Specifically, we believe this new environment will favor shorter duration bonds over long-duration bonds, and lower multiple/higher cash flow equities (Value) over high multiple/low current cash flow equities (Growth).

Low-duration investing is nothing new to us at Ballast - even though our three-year investment horizon seems like an eternity amidst the frenetic media coverage of Wall Street and gamified trading in large caps. With long-duration assets facing a headwind and fixed income facing negative real returns, we believe our “risk first” approach is more important now than ever. While our equity returns are not low-volatility, at least not relative to treasuries, we are confident the portfolio can survive and prosper (regardless of what the market throws at it in the short run) because we invest in real businesses, with real cash flows, with strong competitive positions and run by capable management teams. By hanging tough in the short run and taking advantage of dislocations when the going gets rough, we sleep well and have confidence in the fact that over the long run, small value has compounded wealth faster than other public equity segments and well ahead of inflation.

For more information, please visit: ballastam.com

-The Ballast Team

Important Notes and Disclosures

The investment decisions we make for clients' accounts are subject to various market, economic, and other risks, and there is no guarantee that those investment decisions will always be profitable. Clients are reminded that investing in any security entails risk of loss, which they should be willing to bear. The past performance of the firm or its principal is no guarantee of future results.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment or tax advice. Please consult with a tax advisor to obtain further information. Investors must conduct their own analysis and make their own decisions concerning which securities to buy or sell and when to buy or sell them.

There is no guarantee that any investment strategy will achieve its objectives, generate profits, or avoid losses.

This report contains forward-looking statements within the meaning of the United States federal securities laws. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. For example, forward-looking statements may predict future economic performance, describe plans and objectives of management for future operations and make projections of revenue, investment returns or other financial items. A prospective investor can generally identify forward- looking statements as statements containing the words "will", "believe", "expect", "anticipate", "intend", "contemplate", "estimate", "assume" or other similar expressions. Such forward-looking statements are inherently uncertain, because the matters they describe are subject to known (and unknown) risks, uncertainties, and other unpredictable factors. No representations or warranties are made as to the accuracy of such forward-looking statements.