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How the Capital Cycle Could Impact 2024

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- While the capital cycle fuels the engine of progress, it can also create excesses and inefficiencies.
- The risks associated with many technology companies today are avoidable, yet investors are focused elsewhere.
- While they are not nearly as exciting as technology or AI, industries that are supply constrained, with high barriers to entry and a low risk of competition have the potential to reward patient investors with material outperformance as they become high-return assets while more glamorous companies disappoint.

In life, and certainly in economics and finance, emotion can interfere with rational decision-making. The observed behavior of others can create a bandwagon effect that results in unexpected outcomes. Entrepreneurs and investors have always been drawn to high-return investment opportunities and repelled by low-return ones. This pull from low- and push to high-return prospects is the driver of the capital cycle and is often linked to economic and financial market excesses.

Two easy-to-understand examples are the 1840s British railroad and 1990s internet booms during which vast amounts of capital were needed to fund new technologies. Investment banks, the lubricators of the capital cycle, provided the financial plumbing required to bring together borrowers needing capital and savers seeking high return, and construction was soon underway.

However, the cycle typically doesn't end there. Investment begets investment as more borrowers and risk-takers seek to compete in these new, high-return industries, flooding the market. Investment bankers, incented by commissions rather than by their clients' long-run returns, are quick to create the excess liquidity demanded by those late entrants. But when supply and demand become imbalanced, prices adjust. Our examples show that as too many railroads were built, and too much networking equipment and fiber optics were brought online, supply exceeded demand and prices collapsed, pressuring returns. Since asset prices are ultimately a function of return on capital, stock and bond prices soon fell and recessions began.

Recessions correct market excesses. Enterprises consolidate, and the supply of goods or services falls. But the capital cycle can overshoot this way as well, leading to inadequate supply and elevating returns. Ultimately supply and demand reaches equilibrium when returns on capital are commensurate with the associated economic value of the good or service.

So while the capital cycle fuels the engine of progress, it can also create excesses and inefficiencies in economies and financial markets. Let's explore why that's relevant today.

Looking ahead to 2024

Following the inflation and interest-rate shocks of 2022, investors focused on inflation and monetary policy in 2023. However, I wonder if they were trying to find the answer to the wrong question.

There is a tendency to extrapolate our most recent experiences, particularly when those experiences are as unforgettable as they were in 2022. So, while I'm not dismissing inflation and interest rates, being distracted by them might cause investors to miss the risks and opportunities created by the most recent capital cycle.

Before looking forward we need to look back. Exacerbated by years of artificially suppressed interest rates, massive amounts of capital were made available to providers of technology, particularly coding.

For laymen like me, code is simply software: a set of programmed instructions that offers a return on investment for the customer. Artificial intelligence is software with potentially step-function-changing functionality. While AI has been in development for years, it exploded into the mainstream late last year. Ever since, most technology companies have wanted us to believe that their AI will be a tailwind for returns. But is that likely in the capital cycle construct?

The high-return prospects offered by new software enterprises drew significant levels of fixed investment that brought an explosion of new code. The direction of capital flows is evident in public markets. Since equity is currency, the massive outperformance of select well-known large-cap technology stocks signals the direction of the capital cycle. The history of capital cycles tells us this won't end differently than other periods of capital excesses.

I'm not dismissing the enormous potential economic or financial benefits that AI may bring. But I'm challenging the idea, implied by their lofty stock prices, that the incumbents can achieve lofty returns on capital and that they're immune to new competition and ingenuity. There are avoidable risks in many technology companies today, yet investor focus is elsewhere.

Where are the opportunities?

We see opportunities in companies and industries that are supply-constrained, ones for which the risk of competition and threats to attractive, above-average returns are low. These are often businesses with high barriers to entry that limit new entrants.

We can find numerous examples among suppliers to large end-manufacturers. Prerequisites are typically a good or service that is indispensable, hard to duplicate and not overly costly. We see these opportunities — not only today but over cycles — in suppliers to life sciences, residential real estate and the automotive industries, among others.

- Given the high expense and the years it takes to develop a drug, life science customers value quality, features and product accuracy. When those criteria are met, the risk of switching to a new provider is low. This results in durable, stable revenues and high margins.
- While residential real estate is cyclical, existing homes can represent families' biggest asset, and one that requires protection and capital investment. This is why superior through-cycle returns are offered by many of the suppliers of insulation, paint, doors, cabinets and roofing that also enjoy strong brands and relationships with contractors and big-box retailers.
- The automotive market has been mature for decades and is also very cyclical. It's facing new threats from electric vehicles and a massive demand for capital. One of the most attractive industries within capital goods, auto suppliers, encounters far less competition. Designers of electrical and fiber optic connectors and sensors, with years of innovation behind them and longstanding relationships with automotive manufacturers, help keep both barriers to entry and returns high.

- Industrial gases present another opportunity. Competitive threats are kept at bay by industry consolidation, an increased focus on pricing discipline and a diversified customer base that signs long-term contracts with companies it trusts. The industry is also experiencing secular tailwinds from demand tied to health care, the energy transition and decarbonization.
- Over a century after the railroad industry crashed and consolidated, the industry now finds itself made up of above-average-return businesses. Offering commodity-shipping customers the most efficient mode of transporting goods allows them to exercise pricing power that exceeds the rate of inflation. Their end markets are well diversified, which minimizes volume declines from unforeseen idiosyncratic market cycles.

And there are others. While they not nearly as exciting as technology or AI, their potential to meet investor return expectations could, in my view, reward the patient investor with material outperformance as they become high-return assets while more glamorous companies disappoint.

Conclusion

While the future is unknowable, returns on capital drive financial asset prices over the long run. History has shown that high-return industries invite capital and competition, which ultimately pressures returns. The capital cycle is continuous, and excesses, as well as other opportunities, are created by it. The inefficiencies in this cycle have perhaps been made worse by the market's fixation on interest rates.

Meanwhile, passive investing has taken considerable market share over the past 15 years due to the lack of value created by active managers, and I believe the success of passive and the capital cycle are linked. Passive portfolios are rooted in the past and based on where capital has already flowed, not where it will flow next. Looking backward but investing ahead — to where returns will be versus where they've been — is the essence of patient, fundamentally oriented investing.

I want to thank everyone for reading *Strategist's Corner* and wish you all a Happy New Year!

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