Industry Perspectives - Q3 2022

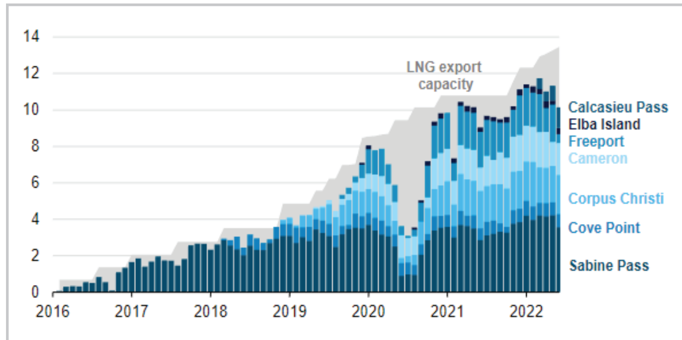
A Variety of Global Factors – Positive and Negative – Continue to Affect U.S. Markets

Global markets declined during the 3rd quarter, as heightened geopolitical strife and inflation-driven central bank interest rate increases have raised market concerns about the trajectory of resulting economic growth and corporate earnings prospects. There is much tension globally and it has been revealed economically, diplomatically, and militarily.

Besides the Russia-Ukraine War, the U.S. and China continue to antagonize one another through provocative actions, especially relating to Taiwan and technology. Taiwan is economically and geopolitically important because Taiwan Semiconductor Manufacturing Company* manufactures (but does not design) most of the world's leading-edge semiconductors. The U.S. government is subsidizing the company's $12 billion, first-ever U.S.-based fabrication site through the recently enacted Chips Act to lessen supply chain risk and spur U.S. semiconductor industry growth. The U.S. also currently denies or restricts critical leading-edge semiconductor exports to China as well as the equipment to make them due to national security concerns. Additionally, other economic tariffs are a drag on, and threat to, economic growth should things worsen between the world's two largest trading partners. China's zero-tolerance COVID policy also has stunted economic growth, but there is hope they may loosen that in conjunction with the upcoming 20th National Congress of the Chinese Communist Party, at which President Xi is expected to become further entrenched as leader. The meeting could include significant anti-American rhetoric and may be a platform to announce responses to perceived U.S. aggressions stifling its ambitions.

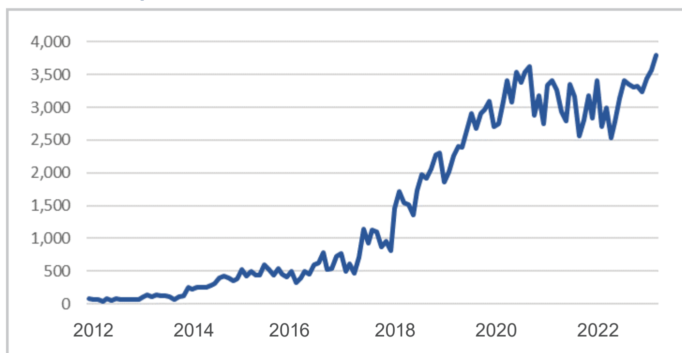
Western Europe's dependence on Russia to supply them with oil and natural gas (~30-40% of demand) has forced it to seek supplies from other places, given Russian supplies either being eschewed by or withheld from Europe (a paradoxical duality). This includes significant increases in oil and liquid natural gas (LNG) exports from the U.S., now the world's largest LNG exporter.

Chart 1:
Monthly U.S. LNG Exports (Jan 2016 - Jun 2022)
billion cubic ft per day



Source: U.S. Energy Information Administration (EIA)

Chart 2:
U.S. Oil Exports *(thousands of barrels)*



Source: U.S. Energy Information Administration (EIA)

Other supply chain challenges continue and have been more acute for some commodities than others, notably for food (especially dairy and wheat) and rent, which are less economically-sensitive and have lower demand elasticity. Other commodities like copper, aluminum, or lumber have corrected more quickly in anticipation of a slowdown in construction spending as interest rates have increased. Besides shipping and production constraints due to tight container/tanker capacity and China's COVID policy, the Russia-Ukraine war has drastically altered world goods trading patterns. This is due to the physical realities and limitations of a war-ravaged infrastructure. Ukraine has historically supplied a significant amount of the world's wheat and sunflower oil exports and is an especially critical source of food for Africa. Embargoes placed on Russian products (principally energy, fertilizer, and mineral exports) and/or supply being withheld by Russia in response, further complicate the picture. The threat of a catastrophic winter looms for western Europe. Rationing of energy supplies and nationalization of energy and electricity industries has begun in Germany and may become widespread throughout Europe. Energy is a critical component cost of manufactured goods, including the production of other commodities, and European consumers and companies are bearing the brunt given curtailment of Russian energy flows. These inflationary problems are exacerbated by droughts that have inhibited hydroelectricity generation in China, impeded normal freighter traffic in Europe due to low river water levels, and threaten not only the U.S. west and southwest regions' long-term electricity generation potential but also the amount of water available to residents to live and for industrial/agricultural uses.

These commodity supply restraints are real and will take some time to work through, but it is also important to consider them in the context of foreign exchange rates. The strong U.S. dollar makes the inflationary challenges much worse for the rest of the world than for the U.S.; since the commodity markets are priced in dollars, they cost more in foreign countries' currency terms. This cushions the U.S. from commodity price increases, relatively speaking. But the strong dollar also makes U.S. exports less competitive and makes the local currency earnings of U.S. companies' foreign subsidiaries worth fewer dollars. This is a significant headwind to revenue and earnings growth for those companies more exposed to foreign demand and a frequently cited reason for caution heading into the next earnings reporting season. There are also reasons to believe such concerns may be overblown and that much of the risk is already priced into the currency and equity markets through recently revised earnings estimates, that currency risks are manageable, or that the U.S. dollar could give back some recent gains before settling into a new, higher trading range if history repeats.

One possible offset to the negative earnings impact of a strong U.S. dollar for U.S. multinational companies is that the relatively higher energy prices and cost inputs for foreign commodity producers (especially in Europe) could make them unable to operate as profitably, which could force them to idle plants. This would tighten overall supply, propping up prices (or limiting downside from weakening demand) and potentially allow U.S. producers to gain global share, as is occurring in the energy markets. The trick will be keeping the inflationary impacts benign while dampening negative earnings implications. Foreign subsidiaries of U.S.-based companies could also be advantaged by strong-dollar capital investment by company headquarters compared to what might be available to local competitors.

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The degree to which this happens will in part be determined by European governments' effectiveness in developing coordinated policies to protect consumers and businesses from the spiked energy costs being confronted, how generous they will be, and how such programs are funded. All the related uncertainty has not helped the Euro either. More fundamentally, future interest rate levels will be a critical factor. Though not the first to act, the U.S. Federal Reserve (the "Fed") has been raising rates more aggressively than the rest of the developed world's central banks, and it seems other countries may have greater incremental rate hikes remaining compared to the U.S. this cycle (see Chart 3).

Chart 3:

Central Bank Interest Rate Moves for Select Countries in 2022

	YE2021 Rate	E3Q2022 Rate	Rate Change	First Increase Announced
United States	**0.25%**	**3.25%**	**3.00%**	**March 2022**
Eurozone (ECB)	0.00%	1.25%	1.25%	July 2022
U.K.	**0.25%**	**2.25%**	**2.00%**	**February 2022**
China	3.80%	3.65%	-0.15%	N/A
Japan	**-0.10%**	**-0.10%**	**0.00%**	**N/A**
South Korea	1.00%	2.50%	1.50%	August 2021
Australia	**0.10%**	**2.35%**	**2.25%**	**May 2022**

Source: Factset

Despite a myriad of negative factors, which are so easy to focus on, there are still positive signs to consider. The banking system is far better capitalized now compared to before the Great Recession, and the labor market is in a strong position to absorb some losses, each of which could help limit economic downside. Although companies may not have confidence to make large capital investments in this uncertain demand environment, they have continued to increase dividends and share buyback programs to the benefit of investors. We know the process of adjusting and normalizing markets, from financials to commodities and other asset classes and industries at home and across the world, can be painful for investors -- after all, we are investors, too -- but our confidence that regularly buying great companies for the long-term is the best way to build and protect wealth is unshaken.

Though not immune to the broad downswing, our bias towards owning high quality, well-financed companies has insulated our clients from the worst of the market during this downturn (as in the past) and we have cash poised to be invested opportunistically. It is hardest to keep investing during the minority of the time the market is in a bear market, but such a consistent approach has been proven successful, even if it occasionally entails "averaging down" on companies you have conviction in for the long-term. Though impossible to precisely time the market bottom, sometime in the next 6-9 months would be consistent with average prior recession-coupled bear market lengths of ~1.4 years and with the historical observation that equity markets typically rise in anticipation of an economic bottom or initial Fed rate cuts. Moreover, as we hit the one-year anniversary of the war and the energy price spike, year-over-year inflation numbers should begin to trend lower, which would likely help the market believe the worst of this inflation cycle is past, even if on a reset, elevated baseline.

Thanks to our valued clients for your trust and best wishes to all of you for a wonderful holiday season.

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*Taiwan Semiconductor Manufacturing Company is owned by the Buffalo International Fund, 2.19% as of 6/30/22; no other Buffalo Fund has a position in the company as of 6/30/22. **Opinions expressed are subject to change at any time, are not guaranteed, and should not be considered investment advice. Earnings growth is not representative of the Funds' future performance. Mutual fund investing involves risk; Principal loss is possible. The Funds may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility than larger companies. The Funds may invest in foreign securities which will involve political, economic and currency risks, greater volatility and differences in accounting methods. This risk is greater in emerging markets. The Funds may invest in lower-rated and non-rated securities which presents a greater risk of loss to principal and interest than higher-rated securities. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities.**

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