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Whipsaw

Shutting down and reopening a $100 trillion global economy within the span of two years was bound to pose some problems. The real marvel is that the process has not gone worse. Eighteen months ago, we were contemplating 20% unemployment. Today, there is a historic worker shortage.

The overall economy is being held back by widespread supply constraints, with some industries impacted more than others. Yet real GDP (adjusted for inflation) surpassed pre-pandemic highs in the second quarter of 2021, and the companies in our EQR strategy most impacted by supply chain disruptions are still expected to earn near-record profits this year[1]—a remarkable feat.

This quarter, we will briefly summarize how four broad factors—supply chain, energy, labor, and global trade—could affect the economy and our holdings, and whether current dislocations are likely to persist.

By supply chain, we refer to production disruptions impacting firms and consumers. One of the most pronounced is the semiconductor shortage. Consumers can't get the cars they want because chipmakers cannot produce enough specialized semiconductors.

How long will this last? No one can say for sure, but this type of shortage is most likely to be temporary. Whether adding productive capacity or building a new factory, such endeavors typically take one to three years at most. Therefore, it is doubtful that shortages due solely to production constraints will continue three years from now, and they will likely end much sooner.

The story gets more complicated from there. No sector is more vital and controversial today than energy. Like semiconductor and other shortages in capital-intensive industries, turning on oil and gas production takes time, but is still a shorter-term issue. Two energy-specific factors, however, could constrain production over a much longer horizon: investor discipline and climate change mitigation.

The context required to understand investor discipline begins with the fracking boom of 2010-2019. The United States more than doubled oil production from less than 6 million to over 12 million barrels per day, surpassing both Saudi Arabia and Russia to become the largest oil and gas producer in the world. Unfortunately, this extraordinary growth did not produce great returns for investors.[2] Capital was abundant, especially debt, and well-funded drillers spent like drunken sailors during the first half of the decade.

The slowdown in China mid-decade and crashing commodity prices caused a temporary decline in production. The market became somewhat more rational, and investors began paying more attention to return on invested capital. Yet the siren song of cheap debt and drilling activity again called, fueling a

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second production boom in the late teens. Drilling then came to a screeching pandemic-induced halt in 2020.

The capital discipline that started to emerge in the mid-teens turned into a capital desert. There were more than 45 bankruptcies of North American upstream energy producers in 2020, second only to 2017, according to law firm Haynes Boone. With so many investor losses over the past six years, capital markets closed to all but the highest quality oil and gas producers. The ACR investment team stepped in during the pandemic and made several energy investments. The bust and subsequent recovery have resulted in good returns, while disciplined capital investment seems to be sticking. We believe these investor-driven constraints will hold for the foreseeable future.

A greater constraint is climate change mitigation. Regardless of where one stands on the necessary urgency of climate change action, a massive multi-year energy transition is unquestionably underway. Timing is important. It would be highly destructive (and impractical) for humanity to suddenly turn off our current non-renewable energy supply. We believe fossil fuels must necessarily play an important role, bridging us to a more sustainable future.

Mandates to increase renewables and reduce fossil fuel production could result in unintended energy supply disruptions for years to come, as the physical constraints of transitioning to intermittent renewable energy are confronted. ACR is not betting on a large rise in energy prices, but we believe we are in a good position to weather the potential storm. Our energy investments represent a direct hedge to such supply shocks, while our investments in financial services firms that benefit from rising interest rates, a likely result of higher prices, represent indirect hedges.

Labor market bargaining power is another possible, more enduring market dynamic. We are somewhat skeptical that today’s labor market strength in the United States will endure of its own volition in the long term. Once the economy cools, labor’s current leverage is likely to dissipate. Yet another force could be in play. China’s labor market has been a source of massive multi-decade supply. Slowing working-age population growth and reduced China trade could result in a permanent increase in global labor market bargaining power and higher wages.

Lastly, this brings us to global trade. As the following chart shows, global trade has increased every decade for more than 50 years. Today, the globalization that shaped the postwar world economy is presently in retreat. No one can forecast whether this regression will last or the implications if it does. However, if the result of rising global trade and lower labor costs was lower prices and increased global productivity, it is possible that higher prices and a reduction in productivity could result from less global trade.

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Source: Worldbank.org. Data is in constant 2010 US dollars. World export of goods and services represents the dollar value of goods and services provided by countries to other countries. This measure excludes employee compensation, investment income, and transfer payments.

Big-picture issues such as these are heady stuff. Fortunately, we believe that great investing is not about getting the major issues of the day right. Rather, great investing is about getting our company-level analysis right.

As for the big picture, we simply need GDP per capita to lumber along at 1.5-2.5% per year in the long term. Fortunately, it has done so for more than 200 years despite bouts of inflation, world wars, and pandemics.

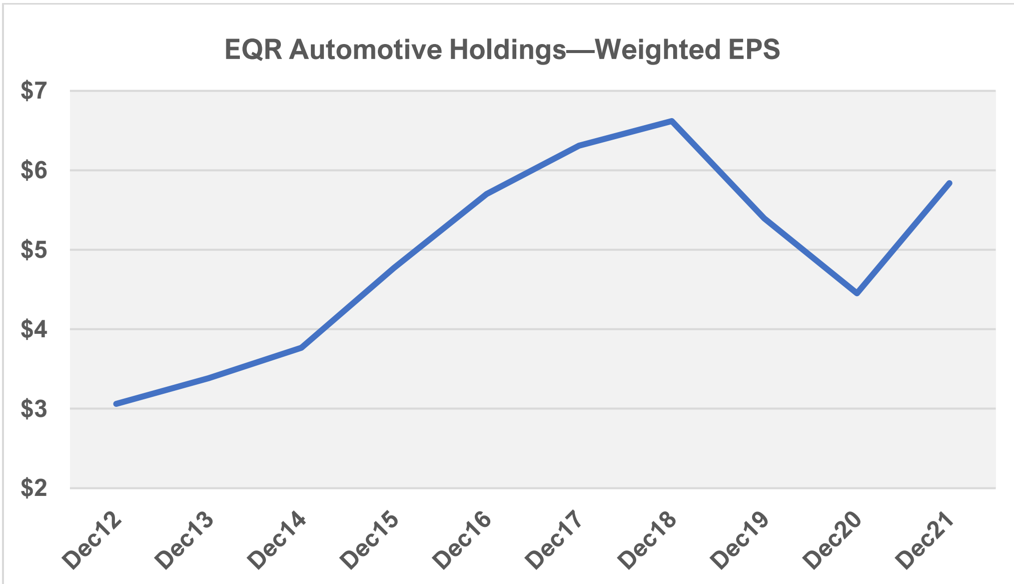
What we must get right is the selection of companies capable of generating satisfactory profits despite industry or other headwinds. We must understand the quality of management, products, markets, competitive positions, and risks. Most of all, we must properly assess the value of corporate profits and pay the right price for them.

On that score, we remain confident of the cash flow-generating ability of our companies today and are pleased with the prices we paid for them. Assuming we are directionally correct about company cash flows, clients will earn satisfactory returns without having to solve all the world's problems.

Nick Tompras
October 2021

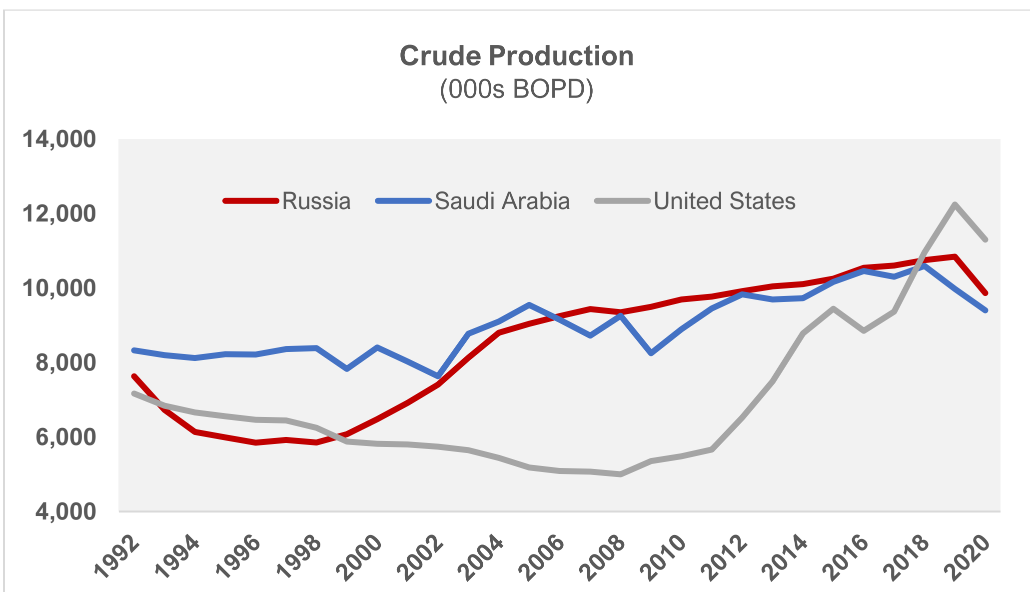
As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

1. EQR Auto Industry Earnings



Source: CapIQ historical normalized EPS through December 2020. CapIQ consensus estimate for December 2021.

2. A History of the Fracking Boom in Three Charts



Source: US EIA, International Crude Oil Production Data. Crude production includes crude oil (inclusive of lease condensate) and does not include NGLs, other liquids, or refinery gains. 2020 "total petroleum and other liquids" production in the US was 18.6k MBOPD. Total petroleum and other liquids production includes crude (inclusive of lease condensate), NGLs, other liquids, and refinery gains. Based on this broader metric US production began to excess Saudi and Russian production in 2013.

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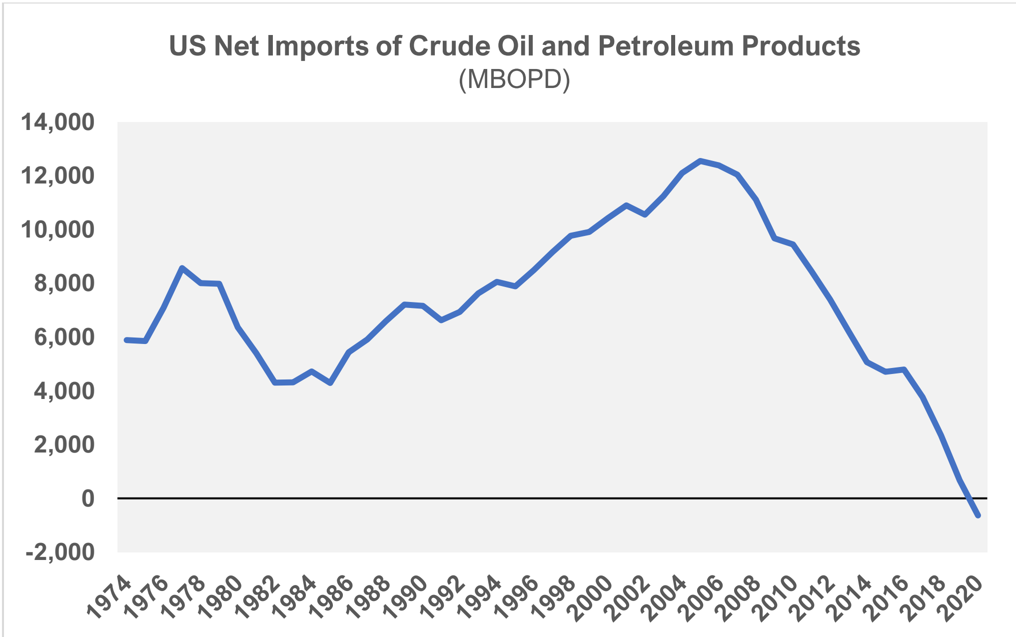
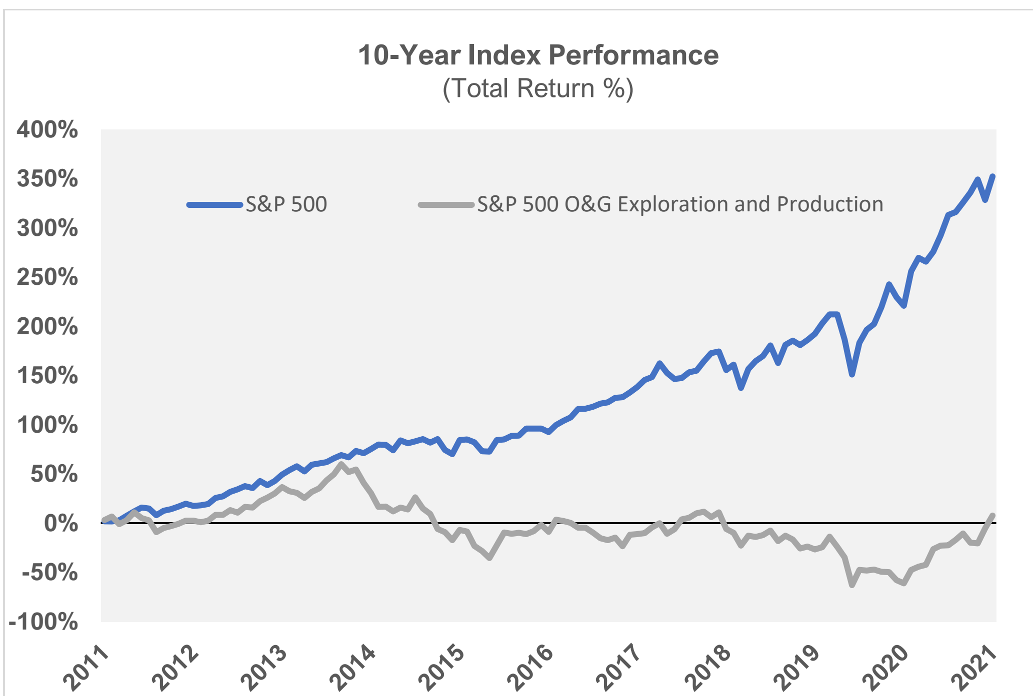


Source: US EIA, - US Net Imports of Crude Oil and Petroleum Products (thousand barrels per day).



Source: CapIQ, total return index performance, data through October 22, 2021.

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