Strategist's Corner

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Capital Is Like Cholesterol

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In brief

- Capital, like cholesterol, plays a critical role in economic health but requires balance. Excess or scarcity of capital leads to financial market cycles, driven by the decisions of investors and capital allocators, which create booms and busts over time.
- Since the global financial crisis, capital has increasingly prioritized financial results over tangible investments, creating high profit margins and returns. However, starting in 2022, factors like supply chain redesign, higher interest rates and emerging technologies such as AI are pressuring business returns and reshaping capital allocation.
- An expected increase in market dispersion will increase the value of financial advice in the world ahead relative to the post-GFC period.

As we age, we're forced to think about, and deal with, health factors that many of us didn't consider earlier in our lives.

Cholesterol is a good example. While it's something I never paid much attention to before, I certainly think about it a lot now that I'm in my 50s. While references to cholesterol are typically followed by the phrase "too high," levels that are too low can also be problematic. Cholesterol serves a mission-critical purpose and without it, we cannot live. It's in a constant state of flow in our bodies, building cells and hormones and performing other critical jobs. Its lack of solubility means it requires a vehicle for transport and cholesterol hitches a ride with lipoproteins.

Capital is similar. Capital performs a mission-critical function in society, is in a constant state of flow in the economy, requires a transporter and too much or too little capital can lead to economic and financial market health problems.

We saw this in the 2000s when too much capital flowed into the construction of too many homes, resulting in too many bad loans and inflating financial institutions' leverage, balance sheet risk and returns. In the decade prior, too much capital funded a gross overbuilding of technology hardware and catalyzed the largest equity valuation bubble in US history.

The non-homeostatic nature of capital is why, throughout history, we have cycles in financial markets and economies. People, and the decisions they make, are the transporters of capital. Investors pull capital from low-return projects to fund better ideas. While capitalism has proven to be the most efficient means of allocating societal resources, it often produces economic and market excesses. Since not all the actions of capital allocators are known to all participants, capital excesses and deficits that are created unknowingly are eventually exposed, driving booms and busts. Wash, rinse, repeat.

Like getting regular bloodwork, investors should constantly check where capital is too abundant and too scarce in the economy and financial markets. Let's explore.

The post-2008 capital cycle

In the face of weak economic and revenue growth following the global financial crisis, globalization allowed developed-market companies to reduce capital intensity by shifting manufacturing to emerging economies. The decrease in tangible fixed investment resulted in the dual benefit of requiring fewer workers. As a result, spending on equipment and labor fell as a percentage of revenue.

Simultaneously, the artificial suppression of interest rates by central banks enabled corporations to take on debt and distribute capital to shareholders by increasing dividends and stock repurchases.

While investment and growth were stagnating, capital continued to flow. Instead of investing in physical goods and engineering, such as real estate in the 2000s or technology hardware in the 1990s, capital was directed towards improving financial results. The shift led to excessive profit margins and returns on capital.

What's changed?

Beginning in 2022, we believe the post-2008 capital cycle started a transition that may affect business returns and ultimately financial markets. We summarize in three categories.

1. Global supply chains previously prioritized efficiency and return maximization over resiliency. However, events such as COVID, conflicts in Europe and the Middle East and tariff policies have prompted a reprioritization. Companies, though still early in the process, have begun cycling capital towards redesigned supply chains that are either closer to home or the customer. While necessary, these changes involve redundant expenditures that will pressure returns for businesses unable to raise prices due to product substitutability.

2. While we are uncertain about where interest rates will settle in a world of higher growth from increased capital expenditures and labor costs, we believe it's unlikely they'll return to the all-time lows observed in the prior cycle. This is especially true given the elevated budget deficits facing the United States. Although interest coverage ratios for many S&P 500 companies are currently high, a significant amount of debt issued in the post-GFC years will be refinanced at much higher rates soon. This will require more capital to be directed to interest expense, putting pressure on returns for businesses unable to raise prices due to product substitutability.

3. Meanwhile, artificial Intelligence is emerging. While there are more unknowns than knowns about its future impact, history has shown that new technologies unlock bottlenecks in society. Companies whose margins result from these bottlenecks have historically seen their businesses commoditized, and experience price deflation and falling profits. While the internet transformed consumer experiences by providing more choice, convenience and better prices, AI may bring a new level of value to consumers by increasing their agency. Large language models will bypass clever advertising and analyze every consumer review to identify products that are a fit for the consumer rather than the producer through clever marketing. Producers of mediocre goods whose economic moat was massive advertising spending may find it difficult to replicate past returns as better fit-for-purpose goods take share. This will pressure returns for businesses unable to raise prices.

Conclusion

The world has undergone significant changes in recent years, with one of the most overlooked being the shift in capital direction by corporations. Like cholesterol, we could perhaps afford to not pay close attention while younger, but that may no longer be wise given the elderly age of this market cycle.

Ultimately, asset prices will reflect actual business returns rather than being whipsawed by headlines. This shift will likely lead to a much more diverse range of financial asset returns than we've seen in recent years, and that's why we believe the value of financial advice will be significantly higher in the future compared with the post-2008 period. ◢

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