# How To Navigate The Falling Tide Of A Down Economy

By Gregory Milano

During a bull market, when the economy is growing, and stock prices are increasing, it is said that the rising tide lifts all boats. If we continue with the boating aphorism, when the tide falls, boats can falter and sometimes run aground.

Companies have been facing growing challenges, and at the top of the list is rising inflation. According to the Bureau of Labor Statistics, the annual inflation rate for the 12 months through June, based on the consumer price index, was 9.1%—the highest in over 40 years, although it subsided a bit in July.

And although inflation is difficult to predict, it's also tough to see it subsiding given the cycle that it creates. Companies face rising input costs, and to protect profit margins, they raise their prices. This increases costs for other companies, which, in turn, raise their prices. Coupled with the tight employment market and increased employee attrition, price increases motivate companies to retain talent by raising wages, which is just like any other cost of inflation.

Another related challenge is the rising cost of capital. When inflation was perennially low, interest rates were also low, as was the cost of equity capital. But facing rising inflation, lenders, including banks and corporate bond holders, seek higher interest rates so they don't lose ground. As an example, the average yield to maturity of 10-year corporate bonds rated BBB by Standard & Poor's was just over 2% at the end of 2020, and this same rate was over 5% in mid-2022.

Cost increases hit companies differently. Some businesses have significant exposure to energy prices, so with gasoline up over 100% since early 2021, they have been hit particularly hard. At the other extreme, for example, lumber prices have dropped by half since year-end, actually helping some industries. I believe the rising cost of capital may hit some businesses more than others, too, with the more capital-intensive businesses suffering the most.

The ability of companies to raise prices and pass these increased operating and capital costs on to their customers depends on the differentiation of their products and services. I find that those with superior offerings can generally raise prices without losing much, if any, sales volume. However, those with undifferentiated products and services—or worse, those that are disadvantaged—may not be able to raise prices enough to overcome the rising costs without a meaningful loss of volume. Just as some boats run aground when the tide falls, some companies can sink in the face of rising costs. I believe this is one of the main reasons for the declining stock market in 2022.

For companies with multiple businesses, regions, brands and product or service lines, I predict that these forces will affect various parts of the portfolio differently. A brand may be very well known but may not be truly loved and desired by consumers, so management may find any attempt to raise prices is followed by a meaningful loss of market share.

In the very same company portfolio, a strongly differentiated brand may be able to recoup the rising costs through price increases and maintain sustainable profitable growth. Indeed, based on my own analysis, although the S&P 500 Index was down about 20% for the first half of 2022, there are over 100 stocks in the index that are up for the year.

These variables make the allocation of capital, innovation and brand building marketing more important yet more difficult to navigate than in recent years. Gone are the flood-tide days when most business units in a multi-business company were likely to earn at least a decent return on new investment.

To remain afloat, develop keen insights to identify the businesses where new investments will create value and those where value will be destroyed. Allocate more resources where you do the best and reduce investment in the areas that no longer cut it in the face of such strong headwinds. I find that now, more than in recent years, company executives must embrace strategic resource allocation (SRA).

As businesses navigate these choppy waters, captains and managements who steer well can perform better and are more likely to be ready for the next upturn.

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