Broadleaf Partners, LLC

The Last Mile

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Now that we are most of the way through earnings, we enter a period we like to call the earnings "lull". In this period, those who closely follow the markets as we do tend to turn their attention to the macroeconomic factors that could influence the markets until a new earnings season begins.

This earnings season has generally been another good one, confounding the bears who have been calling for a recession for the last six quarters. Like a stopped clock that tells accurate time twice per day, they'll eventually be right, but for now, the can has been kicked down the road for at least one more earnings season.

In general, improving supplies of many physical goods has helped produce disinflationary trends in these areas. This doesn't mean that prices are declining, only that they are not inflating at as fast a rate as they once were. At the same time, inflation remains persistent in both implied rents for real estate and wages associated with an increasingly service-oriented economy. Trends towards work-from-home in the suburbs and overbuilding in the multi-family home space may reverse implied rent inflation in coming months, but we're not as convinced that the same will soon prove imminent for wages where labor remains a constraint for many.

On the macro front, if I had a crystal ball on which direction long-term interest rates are headed, I could likely tell you where market leadership might prevail. Since long rates peaked in October, those who follow our framework for understanding the markets will know that innovation-cycle names have led despite earnings pressures and slowing growth rates following pandemic-induced demand bubbles. Economic-cycle names have moved sideways or fallen as long rates have declined in moderation, even though earnings trends and backlogs in these areas, on a relative basis, remain robust. On the credit-cycle side of the ledger, bank failures and the current budget debate have been headwinds for the markets, with lenders pulling back on lending even as workers get higher wages and private equity firms launch popular "private credit" vehicles to fill the funding gaps vacated by banks.

While we may not know much, we do know that sometimes knowing what you don't know can prove as valuable as what you do. In this vein, we loudly and humbly proclaim, that the outlook remains "as clear as mud". At the margin, it is encouraging that the Fed may pause its rate hike campaign to assess any further damage rate hikes may yet cause in their attempts to bring down inflation. On inflation, the Fed has made some progress, but the reported levels themselves and the narrative from nearly eighty earnings calls we have read suggest pressures remain and though pausing, the Fed may not yet be finished.

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Hopefully, the inflation statistics will continue to improve as any pause is in place, setting us up for a glide path to a soft landing. But the betting man in us believes it could be just as likely that more rate hikes could be yet to come. In our opinion, the Fed's long-term goal to get inflation back to two percent may prove unrealistic in a labor-constrained economy where the last mile workers necessary to get things done remain in short supply.

New productivity tools can help on this front to be sure, but in a largely services-based economy, poorer service quality is simply a distant cousin of higher inflation. We're probably just showing our age-related frustration here, but our idea of productivity isn't a chatbot subbing as an artificially intelligent 1-800 line with options one through eight using words rather than digits to pigeonhole us into answering a problem we don't have. Maybe my hotel room doesn't need to be cleaned every day, but should I have to pay the same price for it?

Again, if your service request isn't mainstream and digitally programmable or requires any finesse, a live human being may still be the best bet to solving problems - particularly one with a smile - even if it requires a higher wage. When it is someone you personally know and even trust, even better! Your aging parents just might not get hacked or scammed or require expensive cybersecurity software just to pay a bill! To be sure, bundled cable tv service may have sucked, but I'm not so sure having eight subscription services and having to ask Google to tell you which show is on what streaming service, is much better. Netflix adding ads to their service feels like a step into something quite familiar as opposed to true innovation. Is the toilet the only thing we can honestly say isn't better un-disrupted?

As an aside, Amazon and Costco were among the early leaders in raising their minimum wage above $15/hour several years before the pandemic. That move, along with those of others, was attacked as a very "leftist" idea at the time, sure to destroy jobs in the long run. I think we can all agree that Costco's service levels and value proposition are better today than their competition, even if "inflationary". Perhaps ironically for Bernie Sanders and his supporters, Jeff Bezos may be the one to thank for the $15 minimum wage, showing that our interests are more common than we might be led to believe.

While education is important in society, if where we need workers the most is in "last mile" situations that remain difficult if not impossible to "digitize", price may be among the few tools left to incent new sources of supply. But you also can't create new labor or adopt new technology overnight. It takes time. An artificial emphasis on credential creep is also inflationary, if for no other reason than it contracts the supply of labor and artificially adds to an industry's bureaucratic cost of entrance. Sometimes the best credential is a little bit of elbow grease – a willingness to roll up your sleeves. In an economy in which the focus is on automating everything, doing the dirty work that others pass on may finally pay dividends again.

We would be the first to point out that our performance, while positive on the year, is not up to the high standards we set for ourselves. In all humility and in the spirit of knowing what we do and do not know, we will make a few final closing points.

First, while we remain in the camp that still believes a soft landing is possible and perhaps even probable, we also know that recessions are a fact of life in any economy. Despite the incessant gnashing of teeth by strategists and economists alike, recessions are both normal and unavoidable in the ordinary course of an economic investment cycle. Fortunately, the antidote is a longer-term time horizon, where you have private equity-like liquidity but without the fees.

Two, history shows and my personal experience confirms, that over the long term, markets tend to follow earnings along a positively sloped trajectory. Setbacks do occur, but to get to those new heights you have to stay in the game even when the valleys seem daunting. Call it good old-fashioned work or "last mile" investing, but you still can't get something for nothing. Someone has to pay or put in the effort somewhere along the line.

Three, while at the margin, we are warming to our innovation plays and feel inclined to press these over economic-cycle plays, I also know that this Fed will not be done until inflation is tamed more adequately. Earnings have stabilized for this group, but may still have duration risk associated with any further rate hikes. On that front, a permanent pause is possible and further hikes probable, but rate cuts appear highly unlikely. As a result, we remain diversified, holding both innovation-themed names as well as those economic-cycle names likely equipped to benefit from the last mile, heavy lifting that we all need but too few really want to do anymore.

Our general views remain – growth will likely be broader based than the tech-only bend we've observed in the past decade. Not everything has to be disrupted to be a good investment, nor does never changing guarantee any sort of future. The markets and the economy need time to discover price levels where supply and demand find a new equilibrium, following the events of the very strange last few years. We are confident it will and we will press our bets when we have the spirit-led conviction to do so.

Kindest Regards,

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