2023 and beyond—eight ideas that matter

Investment views
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For the past decade, I have written memos to capture my views on our highest conviction ideas and thoughts on the coming quarters. To date, I've used memos like this one to organize my thoughts regarding what the Franklin Innovation Team is seeing in the marketplace and record our expectations for how these ideas may evolve. This piece captures eight ideas that offer you a glimpse into our thinking on a number of themes that matter to us.

1. **History suggests that the period immediately after a pandemic is met with very good economic growth.** Specifically, labor gains new power which leads to a period of prosperity; recent data indicate that this is already happening. New shocks are often met with hyperbole, such as "this has never happened before." Usually what is really meant is "we haven't seen this before in our lifetime." As we highlighted in our piece last year, war, starvation and pandemics have been the greatest killers in human history;[1] therefore, we have a very rich record of what happens after a pandemic. For example, in England, a country where we have fairly accurate records, we saw a very strong economy in the years following the Bubonic Plague or Black Death. At that time, the mid-1300s, most laborers were serfs and tied to the land; after the pandemic, a wage economy developed in response to the labor shortage. Between 1348 and 1351, England lost almost half its population, and wages rose by two-thirds.[2] In 1918, the flu pandemic lasted three years, and in many ways COVID-19 mirrored this period. Both had four waves of illness and controversial mask mandates.[3] The 1918 pandemic was followed by the Roaring Twenties, a period of very strong economic growth and strong labor markets.

   With that history as a guide, it is very possible that the period after COVID-19 will not be a period of recession and contraction, but rather one in which labor gains power, wages increase, and the economy benefits from the change. We can see it in the numbers already. US women now earn as much or more than men in half of marriages.[4] The bottom half of US households are in the strongest relative financial position in a generation, outgrowing the middle 40% and top 1% as real income growth for the bottom half of the labor force grew, while real incomes for the top half declined.[5] This is good news and fundamental to a thriving economy and democracy.

2. **We expect a stock pickers' market in innovation: Losers finally fail.** In 2020 and 2022, we saw very high correlations amongst higher revenue growth stocks. In the throes of COVID-19, many high growth companies appeared to benefit, but as we emerged from the pandemic, these same companies needed to rationalize. Just as the euphoria of pandemic gains lifted all stock beneficiaries higher, the corresponding selloff was largely indiscriminate, as very profitable high-growth companies, special purpose acquisition companies (SPACs), privates, and unprofitable technology companies that were pandemic

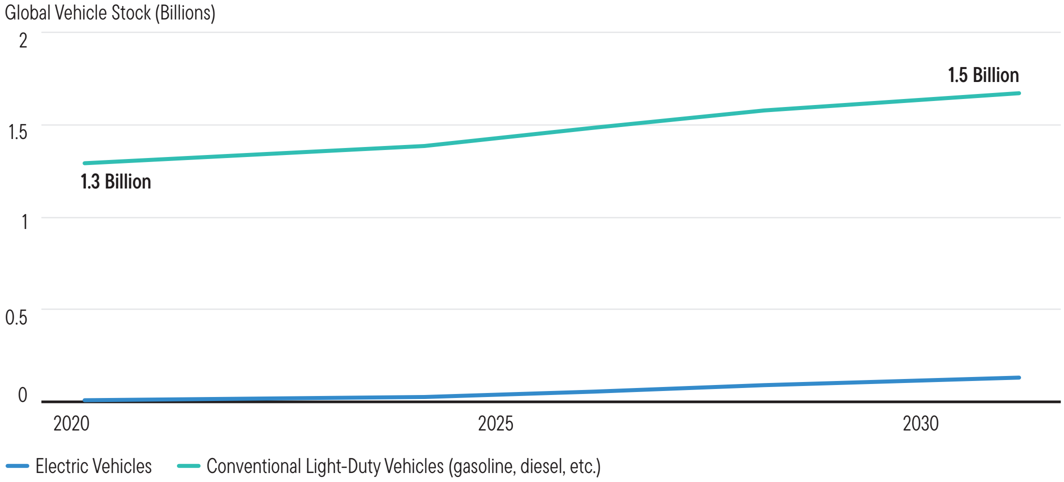
beneficiaries, all moved lower in relative lockstep. In 2023, we expect that the long-term structural winners will start to sort themselves out. Higher interest rates should accelerate the failure of unprofitable tech companies and reduce competition.[6] Structurally profitable companies that can grow through the cycle should be rewarded and enjoy a more benign competitive environment going forward.

3. **2023 will be the year of the chief operating officer (COO),** in which secular growth companies will increasingly focus on disciplined spending and profitability, and in many cases on unwinding or rationalizing the hiring from the pandemic. The COVID-driven gains in e-commerce, payments, mRNA vaccines, office productivity and remote work are here to stay. Companies that leaned into spending as their businesses accelerated will now need to rationalize that spending as their businesses level out. The COO will be critical to revealing the true profit profiles of many growth companies. Consider a choice between investing in company A, which had $250 billion dollars in revenue with a goal to double to $500 billion, or company B, which was already at $500 billion in revenues and needed 280 basis points[7] of operating margin expansion to reach positive free cash flow. In the absence of all other information and assuming that the market capitalization is similar, we would suggest that company B is a better opportunity, with a higher probability for reaching its goal.

4. **Oil is dead. Long live oil.** Today, of the 1.4 billion vehicles in the world, just 20 million are electric vehicles (EVs).[8] The remaining 1.3+ billion run on fossil fuels. By 2030, the US Energy Information Administration (EIA) projects that we will have an install base of 130 million EVs—which will still be less than 9% of the expected global vehicle stock, despite a very aggressive assumed ramp of EV production. The EIA projects that the global stock of fossil-fueled vehicles will not peak until 2038.[9] It's going to take some time to go through this energy transition. The Organization of the Petroleum Exporting Countries (OPEC) controls 40% of global oil production, and their oil exports represent 60% of total petroleum traded internationally,[10] as the West has reduced investment. Even if we had the factory capacity (which we don't) to build more EVs, we would likely need to also invest significantly in materials, such as copper, lithium or cobalt to support production. As a sidenote, nearly 70% of cobalt comes from the Congo,[11] which has a problematic child labor record and raises a concerning ethics question from an

Exhibit 1: Global Vehicle Stock

2020–2030 Estimated (E)



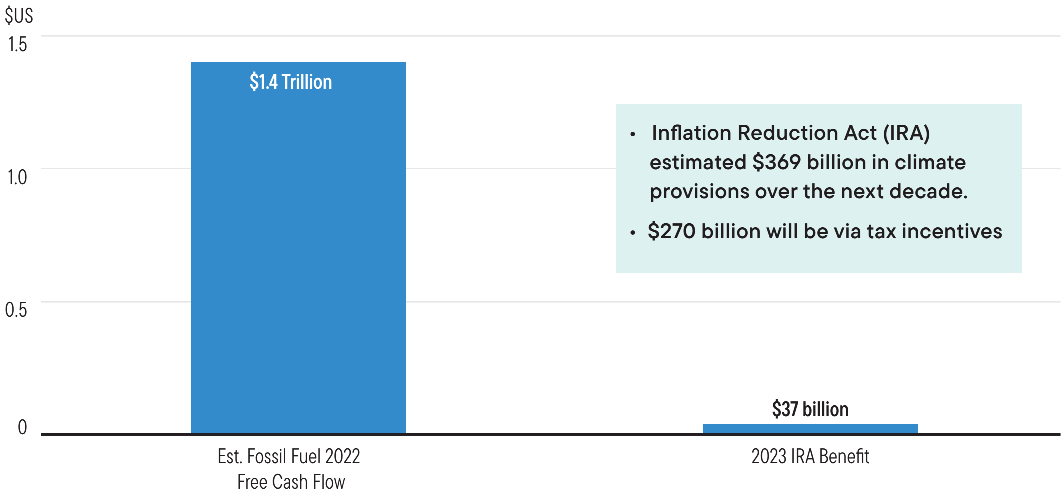
Sources: US Energy Information Administration, International Energy Outlook 2021 Reference Case, Franklin Templeton estimates. There can be no assurance that any estimate, forecast or projection will be realized.

environmental, social and corporate government (ESG) perspective. China's post-pandemic reopening is occurring now; combining an expectation for increasing demand from China with the ongoing needs from the rest of the world, leads us to believe oil demand will remain strong. High commodity prices can necessitate tremendous innovation.

5. **The US Inflation Reduction Act (IRA) signed in 2022 is a likely accelerant of energy transformation. Other countries will need to respond.** The IRA has little to do with reducing inflation. It is important for two reasons. First, it is law—which means a new administration cannot simply overturn it with an executive order. Second, it is likely to generate a similar response in Europe, essentially doubling its impact in US dollar terms. The bulk of the bill focuses on energy transformation and is very generous to solar, hydrogen and wind. We believe this will lead to increased innovation in the renewable space. Some of the early technologies are very exciting, such as fracking geothermal wells, fusion and small nuclear reactors. All will, at some level, see accelerating interest over the next decade (See Exhibit 2).

Exhibit 2: Oil and Gas Companies: Capitalized to Drive Change Alongside Government Programs

2022–2023



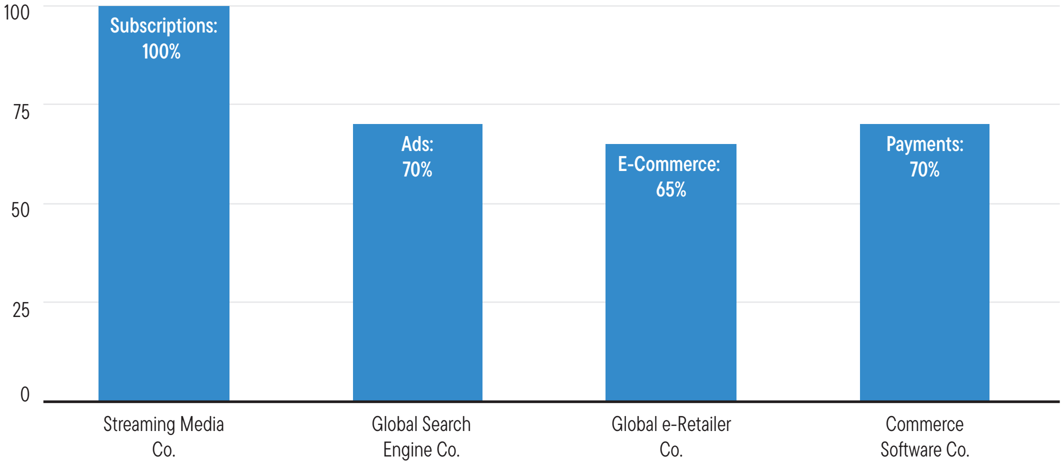
Sources: US Energy Information Administration, International Energy Outlook 2021 Reference Case, Franklin Templeton estimates. There can be no assurance that any estimate, forecast or projection will be realized.

6. **Payments: A button is not enough. Payments are the fourth leg of profitability for internet websites.** Historically, internet websites made money through three primary methods: advertising, subscriptions and e-commerce. Payments have become and will continue to grow as an independent source of revenue. The profit pools from providing payments are large enough that companies can provide tremendous functionality to consumers—functionality such as website development, inventory management or reservation management—in exchange for running payments through the provider's system. This makes the functionality feel like it is "free" to the merchant and aligns the customer's goals (in this case the merchant) with the provider's goals. This creates a framework for a new set of opportunities for investment (See Exhibit 3 on the next page).

7. **mRNA drugs move beyond COVID-19.** Drug companies increasingly realize that one of the best places to improve return on investment (ROI) in the industry is not going to be in the pricing of drugs, but in the efficiency of discovering and producing drugs.[12] New mRNA drugs that build on the lessons learned from the pandemic are now targeting cancer, Ebola, flu and respiratory syncytial virus (RSV). For example, the combination of an mRNA vaccine with immunotherapy treatment has shown an improved recurrence-free survival

Exhibit 3: Percent of Revenue

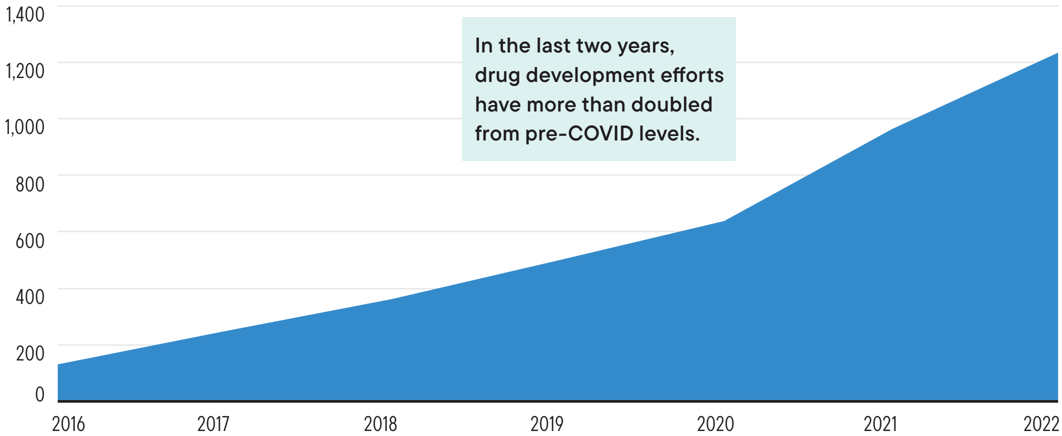
Fiscal Year 2021



Sources: 2021 Company Annual Reports; Netflix, Alphabet, Amazon, Shopify.

Exhibit 4: Drug Development Expected to Accelerate with mRNA's Many Applications

2016–2022



Source: ClinicalTrials.gov, US National Library of Medicine.

rate for high-risk melanoma (skin cancer), reducing risk recurrence or death by 44% in phase 2b trials.[13] Since 2016 there have been over 1,200 mRNA trials initiated[14] with drug development efforts having more than doubled from pre-COVID levels. As this trend accelerates, we expect to see mRNA expand well beyond COVID.

8. **2023 and 2024 may have one of the largest drug launches in history.** In the face of a global obesity epidemic—38% of those over five years old are either overweight or obese[15]—pharmaceutical companies are delivering a solution in a pinch. That pinch, an injection of semaglutide, is already delivering results. Estimated sales of the drug in the United States this year may reach US$4 billion, and the market is forecast to reach over US$150 billion over the next decade.[16] Other pharmaceutical companies are also seeing positive results from weight loss drugs with recipients dropping more than 20% of their weight in trials.[17] Cancer treatments could reach a similar scale. As a point of reference, oncology drugs received US$178 billion in revenue worldwide for 2021.[18] At the same time, there is an argument for governments around the world to be more supportive of addressing weight loss, as obesity has an estimated US$2 trillion impact on the global economy.[19]

There are also risks in investing in this or any asset class. The initial potential of any asset class may not carry over to any specific company or the entire asset class chosen for investment, over any investment time period. Any of the investment assumptions may never come to fruition. Investors should be prepared for potential losses as well as the possibility of invest¬-ment gains. Ideas, products, companies or entire asset classes with positive past performance are not indicative of future results.

Endnotes

1. Source: Moberg, M. and Rogal, K. "War, pandemics & inflation—do shocks accelerate innovation? We think so," *Franklin Templeton*, June 22, 2022.
2. Source: Hoffman, L. Crash Landing: *The Inside Story of How the World's Biggest Companies Survived an Economy on the Brink*, New York: Crown, 2023: p247.
3. Source: Barry, J. M. *The Great Influenza: The Story of the Deadliest Pandemic in History*, New York: Penguin Books, 2005.
4. Source: Saraiva, A.and Cachero, P. "US women now make as much or more than men in half of marriages," *Bloomberg*, April 13, 2023.
5. Source: Cachero, P. "The bottom 50% of Americans are building wealth even as inflation bites," *Bloomberg*, August 29, 2022.
6. Source: Moberg, M., "Innovation Insights: Forest fires and innovation—the case for long-term thinking," *Franklin Templeto*n, August, 29 2022.
7. A basis point (bps) is one one-hundredth of one percentage point (1/100% or 0.01%).
8. Source: US Energy Information Administration, "EIA projects global conventional vehicle fleet will peak in 2038," October 26, 2021.
9. Ibid.
10. Source: US Energy Information Administration, "What drives crude oil prices?" May 9, 2023.
11. Source: Kelly, L. "Top 10 cobalt producers by country (updated 2023)," *Investing News Network*, February 23, 2023.
12. Source: "Thermo Fisher's CEO on the Golden Age of Biotech," *MarketWatch*, January 19, 2023.
13. Source: Feldman, J. "Personalized mRNA cancer vaccine reduces rate of recurrence in melanoma," *Targeted Oncology*, December 14, 2022.
14. Source: ClinicalTrials.gov, US National Library of Medicine.
15. Source: "A new class of drugs for weight loss could end obesity," *The Economist*, March 2, 2023.
16. Ibid.
17. Source: Reuters, "Eli Lilly gets FDA's speedy review for obesity drug," October 6, 2022.
18. Source: Statista, "Oncology Drugs–Worldwide," January 2023.
19. Source: Dobbs, R., et al. "Overcoming obesity: An initial economic analysis," *McKinsey Global Institute*, November 2014.

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