ESCALA PARTNERS

February 2021

MONTHLY AGENDA - REOPENING, ROTATION, REFLATION

ESCALA
PARTNERS

Reopening, rotation, reflation

Reopening, rotation, reflation

Over the course of the last twelve months, the world has progressed through three broad phases of the recovery. The first, occurring in Q2 and Q3 of last year was around the growing understanding of the virus and its management through social distancing, etc. Large cap, growth biased stocks benefited at this time.

The second phase, around Q4 of last year, centred on positive news on the efficacy of multiple vaccines. Optimism grew that the very “event” that caused the global recession was in the process of being addressed. This helped to lift cyclical sectors like small cap stocks and emerging markets.

This month entered the third phase – the reflation phase. Vaccination programs have begun in earnest, case numbers are coming down and confidence has grown in the ability of economies to reopen. The recovery is now being priced by other asset classes including commodities and fixed income.

Naturally, being forward looking, the market will look toward the fourth phase, inflation. We believe this is premature and is more a story for later this year, or into next year.

1. Reopening

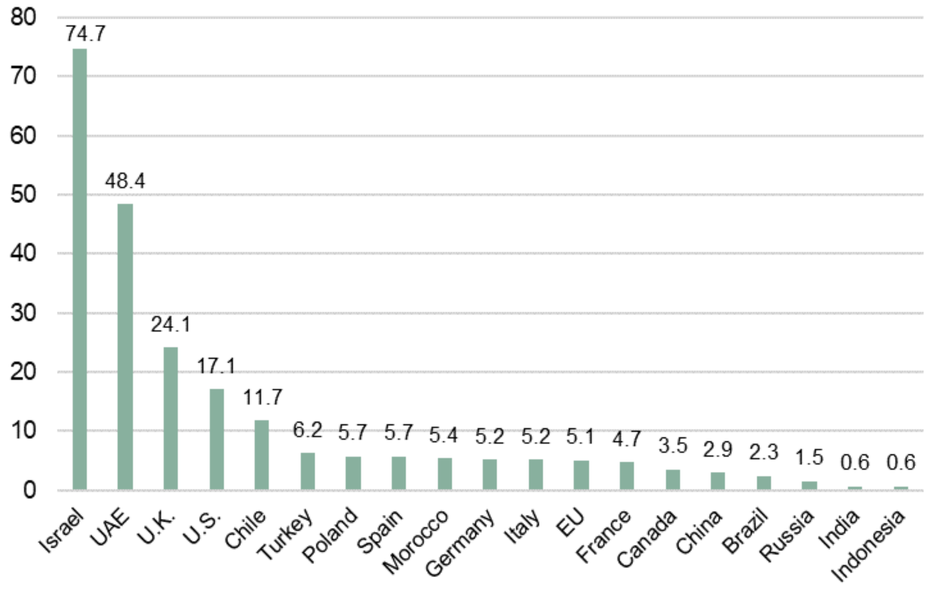
Reopening

The biggest vaccination campaign in history is now underway. So far, more than 181 million doses have been administered across 78 countries at a rate of 6.2 million doses per day. A total of seven vaccines are now available for public use.

Case numbers are declining significantly, and vaccines are working. Data from Israel, the leading country in vaccinations, shows that vaccines play a role in reducing cases. Israel has reported a 94% drop in symptomatic Covid-19 infections among 600,000 people who received two doses of Pfizer’s vaccine.

Israel is also seeing a sharp decline in hospitalisations and there is no indication that protection against severe illness is compromised by the new variants.

Chart 1. Vaccine doses per 100 people



Source: Bloomberg Vaccine Tracker

In the U.S., more Americans have now received at least one dose than have tested positive for the virus since the pandemic began. At the current rate of 1.6

million doses per day, it will take an estimated eight months to cover 75% of the population with a two-dose vaccine.

Up to 15 billion doses are needed globally to protect 80-90% of the global population. This target is expected to be met by 2022 even though most vaccines require two doses.

Vaccination programs are also well underway in emerging markets. India has inoculated over 8m people while Indonesia's tally stands at 1.6m, according to Bloomberg's Covid-19 Tracker.

Run rates are expected to ramp up in coming weeks and months: manufacturing capacity is expanding, new vaccines are being added to the pipeline, regulators are endorsing longer intervals between doses, and the final mile is getting more efficient. And importantly, public attitudes toward vaccines are improving, not least in notoriously sceptical countries such as France.

There is likely to be a virtuous cycle between rising vaccination coverage and falling hospitalizations: the more pressure is taken off the healthcare system, the more capacity there will be for vaccinations.

The political and scientific consensus is seen shifting towards reopening the economy once those most at risk are protected, rather than waiting for herd immunity. In any case, herd immunity could be reached sooner than vaccination rates imply - seasonally lower transmission rates in the northern hemisphere summer months will offer a bridge until even young people are vaccinated, and up to a third of them will have built natural immunity anyway.

All this bodes well for the reopening of economies.

2. Rotation

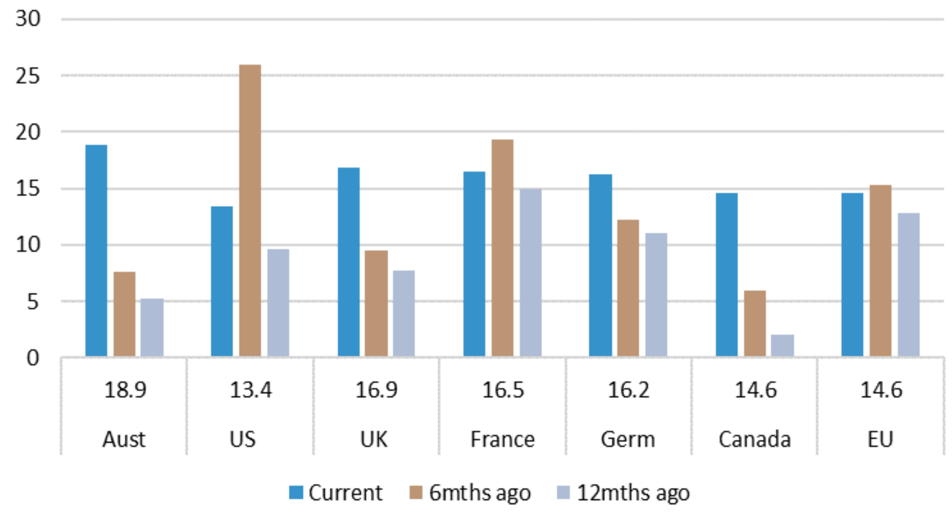
Rotation

Reopening means the pent-up demand that has been so well supported by record fiscal and monetary stimulus can start to be released. The recession appears to be behind us in most countries, and the early stages of an economic expansion are taking shape. We have noted previously how small cap stocks tend to do better than large cap stocks at this point in a recovery phase (see "Monthly Agenda: Time for small to shine?", October 2020).

A reopening allows the real economy to begin growing again. Unlike during the global financial crisis, fiscal policy is now mainly targeted at the "real" economy - business investment and consumer spending. Together, these two sectors make up around three quarters of a developed economy's total GDP. The policy is aimed at bringing about so-called 'multiplier effects', whereby stimulating growth automatically leads to a further acceleration in growth.

The boost to household balance sheets alone has been significant. In Australia, the current saving rate is sitting at 18.9%, almost four-times its level twelve months ago.

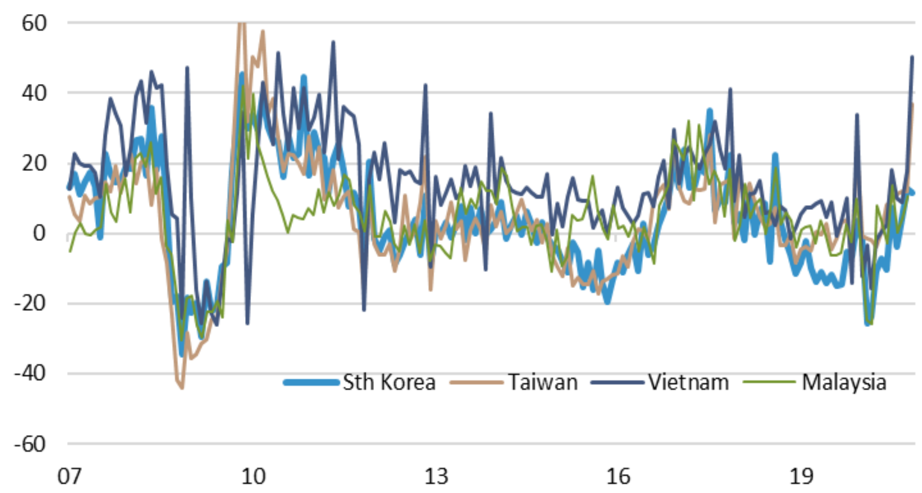
Chart 2. Household saving rates for selected countries (%)



Source: Bloomberg

Some of that pent-up demand is already being spent on goods. This is helping to boost production activity in places like China, South Korea, Vietnam and Taiwan. There is a very strong correlation between consumer demand in developed economies like the US and production activity in Asian emerging markets (see also "Monthly Agenda: The emerging recovery gets a tick", November 2020).

Chart 3. Asian exports (yoy %)



Source: Bloomberg

Will we see a rotation from growth to value?

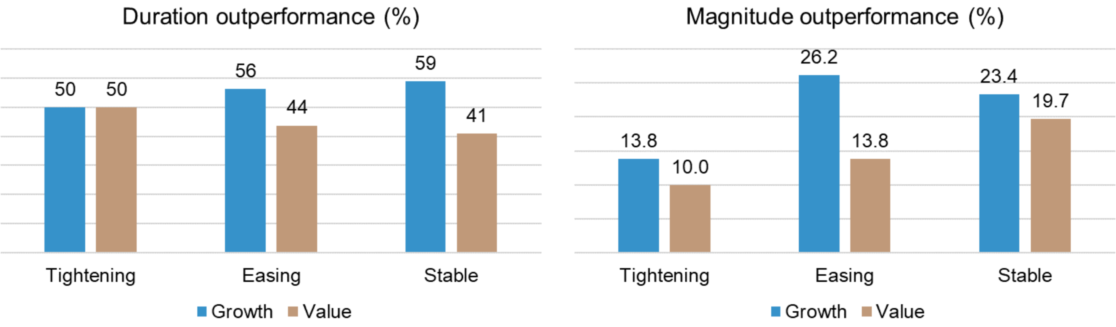
There is a lot of talk about whether we will see a rotation out of growth biased equities into value as a result of the economic recovery.

The outperformance of value over growth has been relatively modest so far despite a positive cyclical outlook. Year-to-date value stocks are up 5.8% while growth stocks are up 3.7%. It is important to note that both value and growth biased stocks have historically responded positively to rising bond yields, at least initially, because it implies faster economic growth and hence faster earnings growth.

Trying to time when to rotate out of growth into value is difficult and imprecise. Looking at the performance of US value versus growth stocks since 1980 we find that during tightening cycles growth outperforms value 50% of the time and during easing cycles growth outperforms 56% of the time. During periods of stable monetary policy, growth outperforms value 59% of the time.

A clearer picture is revealed when we look at the magnitude of the outperformance. The return from US growth stocks during a tightening cycle is on average 13.8% versus 10.0% for value stocks. During an easing cycle, the average performance from growth is 26.2% versus 13.8% for value. During periods of stable interest rates the average return from growth has been 23.4% versus 19.7% for value.

Chart 4. Growth versus value style during easing/tightening cycles



Source: Escala, Bloomberg

We believe it is too difficult to try and time the market based on value or growth style. Unlike the case between large cap and small caps or emerging markets and developed markets, the thesis to rotate into value is not compelling to us. Instead, we try and select fund managers than can perform well in any cycle.

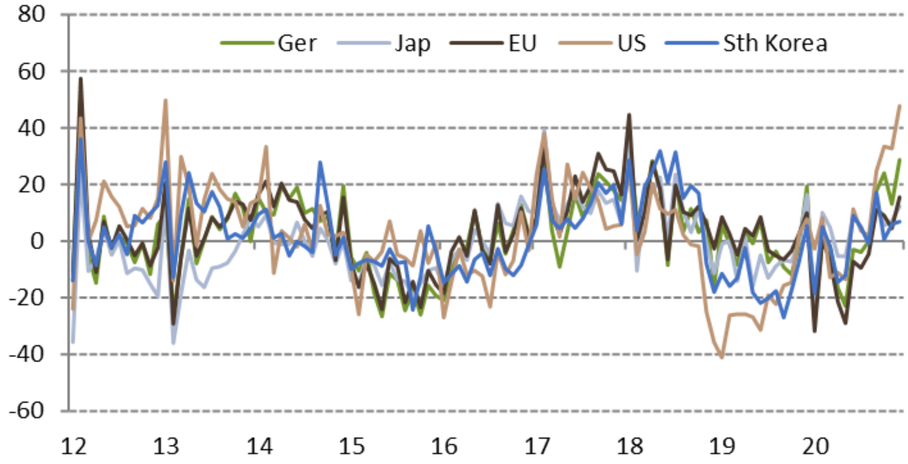
3. Reflation

Reflation

Reflation occurs when the recovery becomes more broad-based and widespread. This is when the recovery draws in other asset classes, not just equities. Reflation is therefore associated with higher costs – higher input costs, financing costs, labour costs. In this phase we tend to see profit margins either stabilise or grow at a slower pace depending on how rapid the increased cost pressure is.

We can see from Chart 5. that manufacturing activity in China has resulted in a surge in imports.

Chart 5. China imports from the top 5 import partners (yoy %)

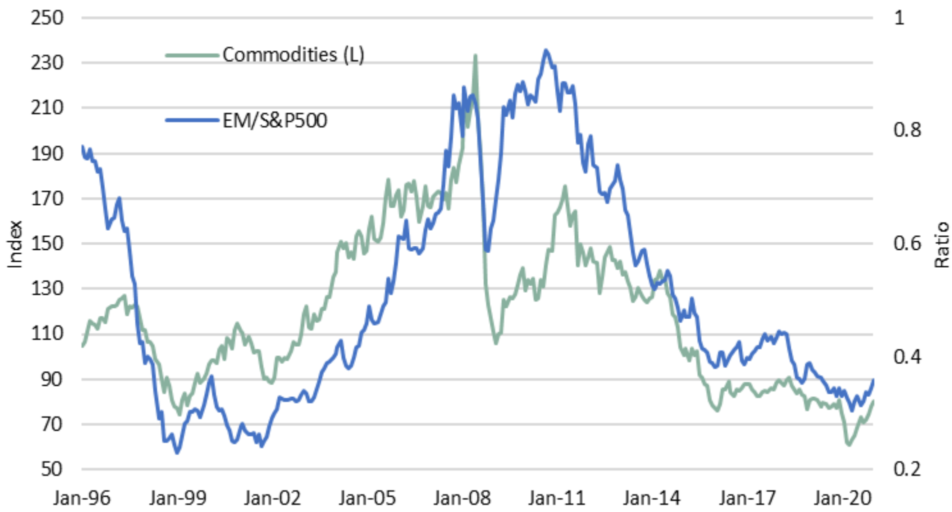


Source: Bloomberg

This is not only boosting economic activity among China's trading partners, it is also lifting commodity prices. Many of the goods China imports are commodities – crude oil, petroleum gas, coal, iron ore, aluminium, nickel, copper, gems, soy beans and precious metals to name a few (see Chart 19.).

Emerging markets have been performing well since late last year but in the reflation scenario, when commodity prices begin to rise as well, emerging markets more broadly begin to take the lead over developed markets like the US.

Chart 6. Emerging markets outperform when commodities lift



Source: Bloomberg

Reflation now, inflation later

The reflation trade is powering assets tied to economic growth, including commodities and cyclical stocks, and price pressure is emerging. This is exactly what policy makers want to see. Nothing sends a chill down the spine of a central banker more than the word deflation. Deflation (falling prices) reduces the effectiveness of monetary policy by putting upward pressure on real interest rates.

The consequence of higher commodity prices is a weaker US dollar. A weaker US dollar will put upward pressure on import prices and hence inflation more generally. There is still a long way to go on this front however (import prices are growing at just 0.9% yoy) and the link into consumer prices is not straight forward.

Inflation is something that needs to be watched closely, however. And as the reflation phase continues, we expect to see inflation move up as excess capacity in the economy is depleted.

All about the US dollar

Eventually, the reflation trade will come full circle as rising bond yields put upward pressure on short-dated bond yields (via higher inflation expectations), putting upward pressure on the US dollar, tightening financial conditions and so putting downward pressure on equities.

The trade-weighted value of the US dollar has a fairly consistent inverse relationship with risk assets like equities. That is, a higher dollar tends to be associated with lower equities. One explanation for this is that many large U.S. companies earn a good proportion of their revenue from offshore. Overall, for the S&P500, the share is around 30% but for Apple for example the share is more like 60%. As the dollar rises, the domestic value of their income earned abroad falls.

It is not just U.S. shares that suffer when the dollar lifts. A higher dollar reduces the demand for dollar-priced commodities and so lowers the benchmark price. Commodity-producing nations and companies are negatively affected as a result.

So for equity investors, the key to watch is the impact of higher bond yields on the US dollar.

Which bond yield is the most important?

Historically, the US dollar is most sensitive to shorter term bond yields. Over the last 20 years, there is a statistically significant positive relationship between the US dollar and the US 2-year bond yield. That is, higher 2-year yields are associated with a higher US dollar.

The explanation here is in the close relationship between 2-year yields and the official interest rate (the Federal Funds Rate) (see Chart 16). As the chart below shows, the 2-year bond yield in the US is extremely well anchored right now thanks to the words and deeds of the US Federal Reserve.

Chart 7. US 10-year and 2-year bond yields (%)

Source: Bloomberg

While we may see bouts of US dollar strength, the overall direction of travel appears more likely to be down given the ongoing participation of the US Federal Reserve in debasing the currency and keeping interest rates low. This will be supportive of higher commodity prices and hence emerging market economies.

Investment implications

Investment implications

We maintain our underweight positions in cash and fixed income and overweight in Australian and Emerging Asia equities and overweight in Alternatives. Allocating part of your equity allocation to small cap companies also makes sense at this point in the cycle.

Two points are worth making.

First, we note our current thinking has become consensus, after being contrarian for much of the last six months. The crowd is very much moving into equities right now with global macro hedge funds favourable toward equities again.

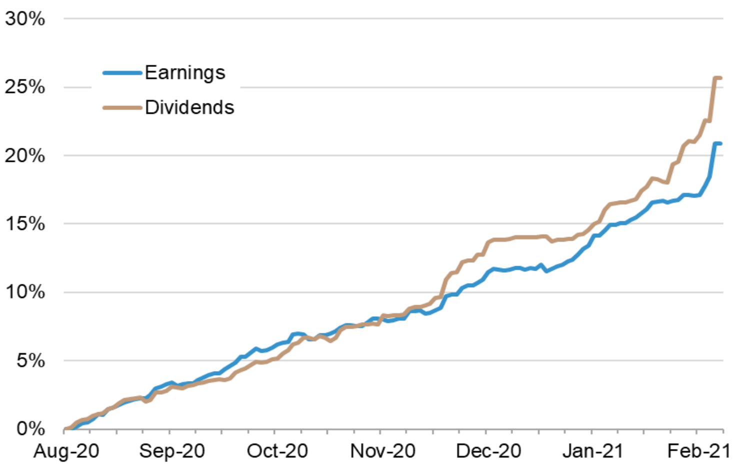
Now is a good time to remember that just because a position is crowded doesn't mean it's wrong. However, history does tell us that when strong consensus expectations and crowded positions build up, the room for disappointment grows and a potentially sharp re-pricing can follow if things don't play out as expected. Compressed springs have a habit of flying open unexpectedly.

For this reason, we like to ensure we have airbags in our portfolios, just in case. Right now, our airbag is to be 100% unhedged in international equities. If we do see the spring fly open, the US dollar will likely rise and act as a cushion under our returns.

Second, we are conscious of the speed at which this recovery is travelling – faster than any recovery that has come before it. The size and shape of the stimulus together with the soundness of underlying economic fundamentals suggests excess capacity may be depleted faster than expected. We will be watching for signs of this and what, if any, impact it has on policymakers this year.

.

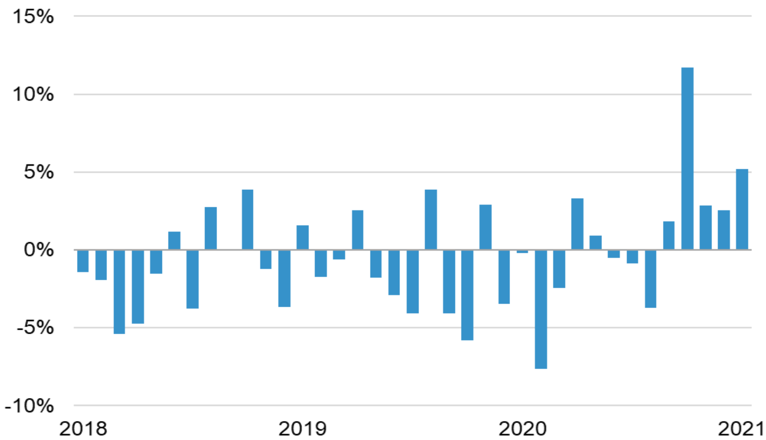
Chart 8: ASX 200 Earnings and Dividends Recovery



Source: Bloomberg

Through the COVID crisis, dividends from Australian listed companies were cut by a greater degree than the decline in earnings. This was attributed to several factors, including a cautious approach by companies in the face of uncertainty, regulatory-enforced capital retention for the major banks, and prevailing high payout ratios leading into the crisis. With the earnings recovery now well underway and an improving outlook, forward dividend estimates are also rising quickly and have risen nearly 5% more than earnings since August.

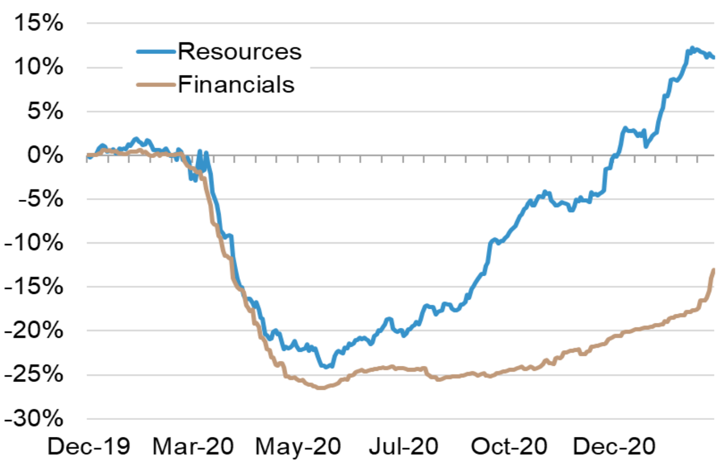
Chart 9: MSCI Australia: Value – Growth (Monthly)



Source: Bloomberg

Vaccine news in early November was the catalyst for a significant rotation in equity markets, including Australia, with out-of-favour cyclicals and value stocks rallying on these positive announcements. This trend continued over the period of December until present, albeit at a slower pace, unwinding some of the large underperformance of value over an extended period of time.

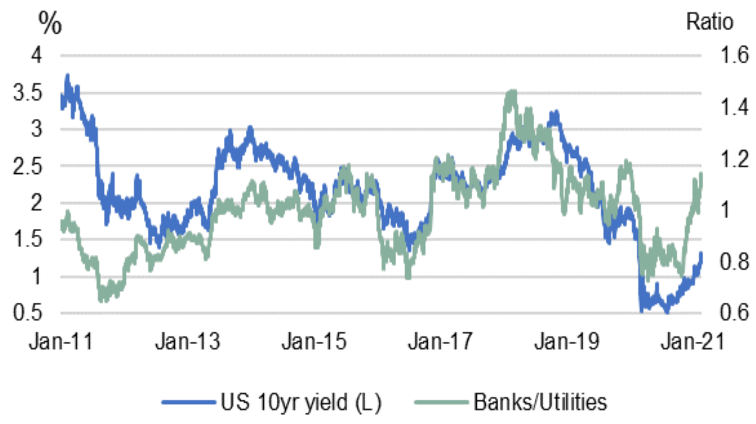
Chart 10: Resources and Financials Earnings: Upward Momentum



Source: Bloomberg

The resources sector was key in supporting the returns of the Australian equity market in 2020, with earnings rising quickly in the second half of the year on the back of stronger commodity prices. The other large cyclical sector - financials - is now starting to show signs of a turnaround with solid results reported this month, which could mark the first time in years that both sectors have positive momentum.

Chart 11: Banks / Utilities rise with bond yields

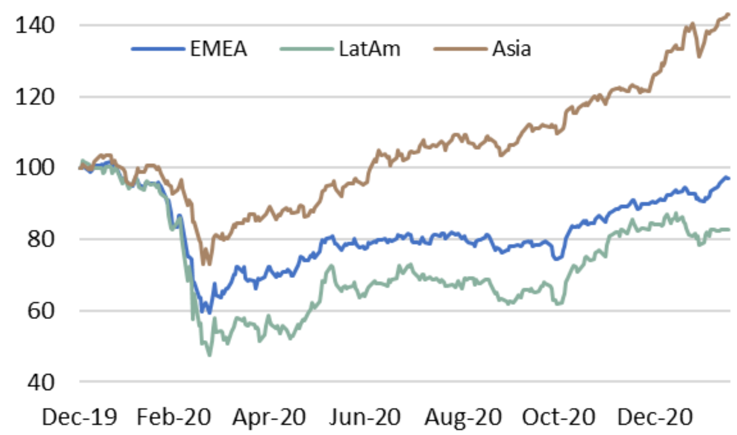


Source: Bloomberg

Utilities are a classic bond proxy while banks traditionally get a boost from rising yields and a steepening yield curve. The ratio between banks and utilities has steadily been rising the past few months, in line with 10-year Treasury yields.

It's not just the reflation trade that's boosting banks. The fundamentals support it too. S&P 500 banks have posted a 4Q earnings surprise of ~38%, versus ~1.6% for utilities. They're also estimated to post 2021 EPS growth of almost 34% (although it is coming off a worse 2020 base) versus utilities at ~12%. Banks are also a natural beneficiary of a push into cyclicals amid optimism around more pandemic aid and an economic recovery.

Chart 12: EM Equities being led by Asia (Index: 31/12/19=100)



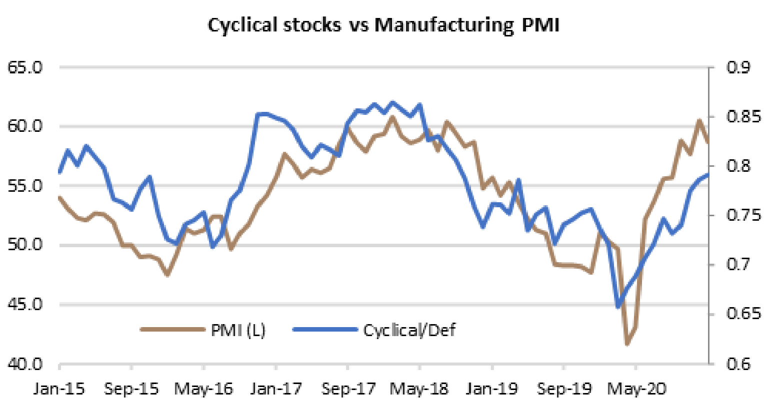
Source: Bloomberg

Asian emerging markets, the manufacturers of the world, are doing their best to keep the supply of goods up to cash-rich households in the West.

So far, other emerging market regions have lagged the recovery. This makes sense given the likes of Brazil is more of a commodity producer than a goods exporter. In fact, Brazil's economy is relatively closed. Exports represent just 14% of Brazil's GDP. In contrast, South Korean exports are 40% of the economy.

Brazil will benefit in the reflation phase of the recovery, however, as commodity prices boost the earnings of its miners.

Chart 13: US Cyclicals still following the playbook



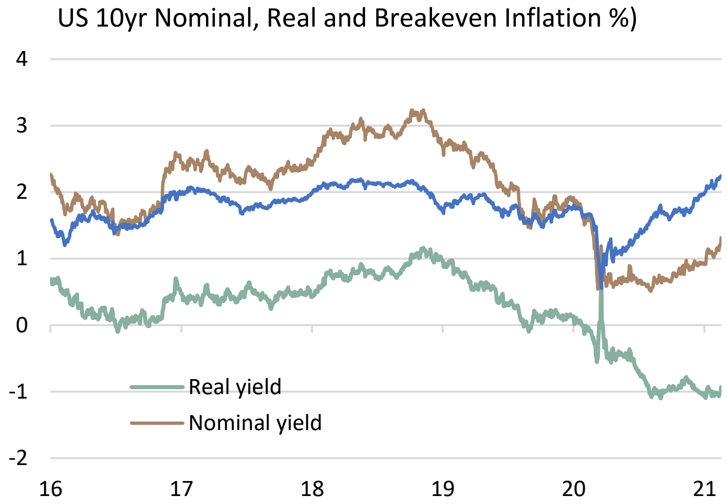
Source: Bloomberg

The close correlation between the US manufacturing activity index (PMI) and the ratio of US cyclical sectors to defensives remains in place and in fact suggests the ratio has been lagging a little in recent months.

Cyclicals are expected to benefit the most from the reopening of the economy.

Key to cyclicals from here is further progress on the vaccination program and the delivery of the $1.9 trillion Biden fiscal stimulus in mid-March.

Chart 14: Bonds begin to price in the recovery

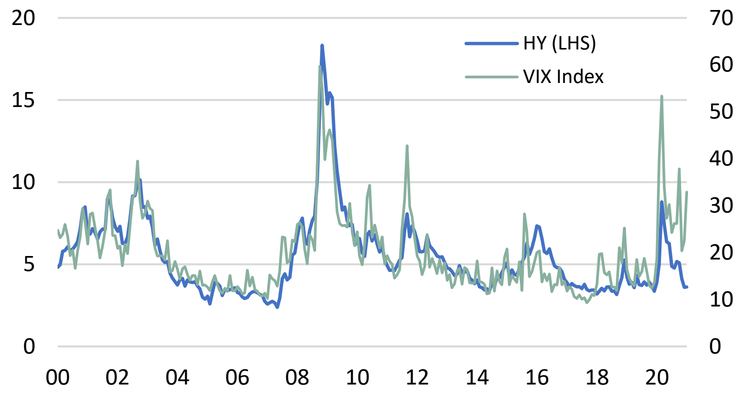


Source: Bloomberg

The fixed income story for February was the rise in bond yields. Nominal bond yields are made up of two broad components – real yields and inflation expectations. So far, most of the rise has been driven by higher inflation expectations. Real yields remain in negative territory and therefore stimulatory for equities. We are watching real yields closely, however.

The US Federal Reserve meeting minutes reiterated that policy makers view the economy as likely to require stimulus for “quite some time,” with a willingness to dismiss any leap in inflation over coming months as temporary.

Chart 15: High yield bond spreads and equity market volatility

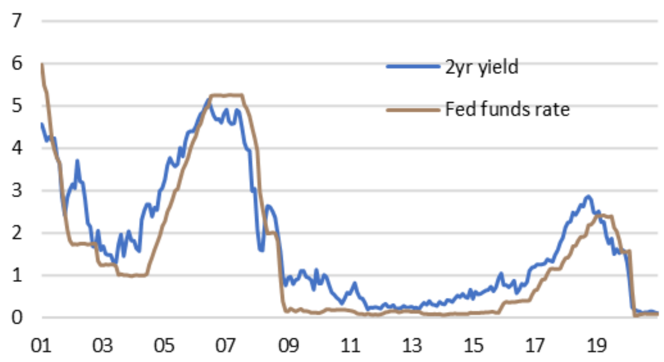


Source: Bloomberg

Investors are building bets against the largest corporate debt exchange-traded fund as credit spreads shrink and interest rates rise. with the vaccine rollout underway and an economic reopening in sight, investment-grade credit spreads to Treasuries have tightened sharply. Meanwhile, building reflation expectations have boosted long-dated Treasury yields to the highest levels in a year.

Judging by the historically tight relationship between credit spreads and volatility, credit is looking expensive.

Chart 16: 2-year bond yields lead official interest rates in the US

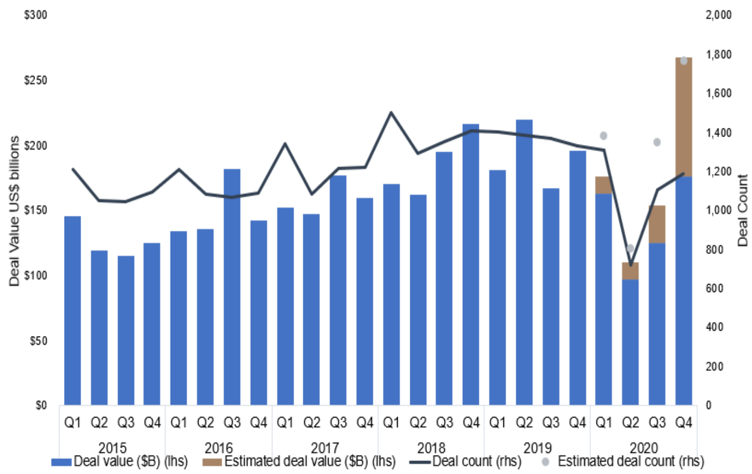


Source: Bloomberg

Changes in two-year yields have impacted the effective fed funds rate for the last twenty years and by default, broader interest rate levels. When that starts to break out, expect the Fed to be not too far behind.

Judging by the most recent minutes from the US Federal Reserve meeting, we shouldn’t expect that to occur anytime soon. But the minutes went out of their way to dismiss inflation fears, waving away the base effect issue and suggesting that underlying inflation pressure is modest. Most participants in the meeting view risks as skewed to the downside.

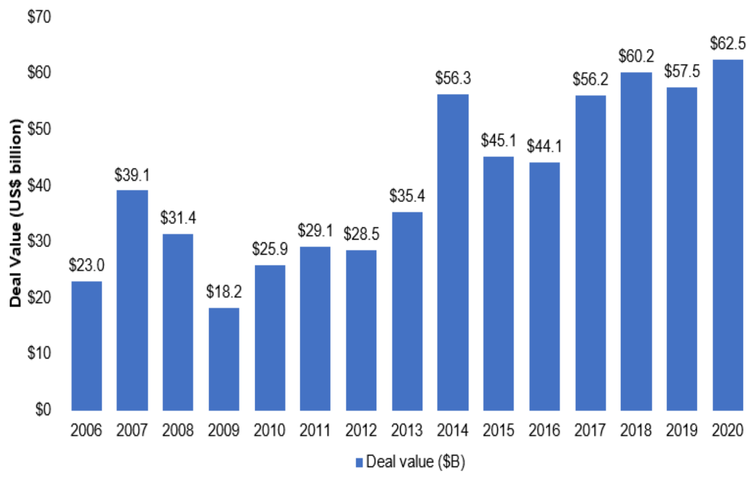
Chart 17: Private equity activity picks up in Q4



Source: Pitchbook

Private Equity (PE) deal flow rebounded strongly in Q4 2020 following a sharp decline in activity around the middle of the year. Fourth quarter activity in the US, the world's largest PE market, is estimated to be a record in terms of both the number of transactions that took place (1,770 deals) and the total value of deals ($267.8 billion). Tech and healthcare continue to be the focus for PE funds with 38% of all deals done in 2020 across the two sectors. With record amounts of dry powder at the disposal of PE fund managers, 2021 could yet be another record year for deal flow activity.

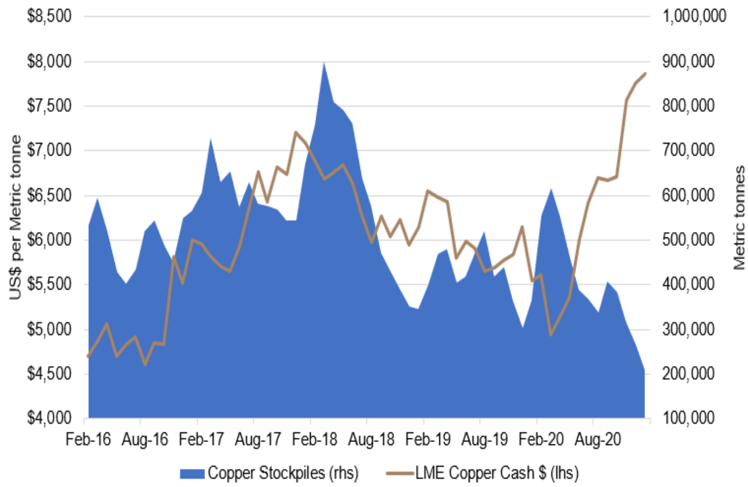
Chart 18: Growth equity's continued rise in value



Source: Pitchbook

Despite the slowdown in total annual deal value for 2020, growth equity was one area that continued to see a strong increase in deal flow, growing by 9% to $62.5 billion in 2020 as PE managers remain bullish on the segment. Often characterised as the middle ground between venture capital and traditional leveraged buyout deals, growth equity has become an increasing focus for PE managers targeting companies that have enjoyed strong organic growth now looking for capital to scale up and achieve the next stage of growth. Silver Lake's investment in Airbnb is one such example from 2020, investing $1 billion at an $18 billion valuation, the company's market cap is now greater than $120 billion.

Chart 19: Copper stockpiles lowest in over five years



Source: Bloomberg

Copper prices have surged in recent months back toward multiyear highs as optimism of a global economic recovery continues to pick up. With many analysts forecasting the beginning of the next commodity super cycle, demand for copper which is a key material used in many clean energy technologies has risen strongly. Copper supplies shrank to their lowest levels since 2008, exchange tracked supplies stand at a little above 200,000 tonnes compared with annual average demand of 23 million tonnes, less than 1% of 2021 forecast consumption levels.

Contact

Chief Investment Office

Tracey McNaughton, CFA
Chief Investment Officer

David Bruty, CFA
Investment Analyst

Darragh Kennelly, CFA
Investment Analyst

Josh Lin
Investment Analyst

Escala Partners Pty Ltd

Melbourne:
Level 19, 90 Collins Street
Melbourne Victoria 3000
Telephone: 03 8651 2600

Sydney:
Level 25, Governor Macquarie Tower
1 Farrer Place
Sydney NSW 2000
Telephone: 02 9102 2600

Perth:
2/328 Stirling Highway,
Claremont WA 6010
Telephone: 08 6282 2600

information@escalapartners.com.au
www.escalapartners.com.au

Disclaimer