ESCALA
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March 2021

MONTHLY AGENDA - LIFE IN THE POST-PAN WORLD

The post-pan world

Navigating the past twelve months in financial markets has required a deft hand and a clear and organised mind. The speed of travel has been breakneck both on the way down and on the way back up.

With the “event” that triggered this journey now in the process of being addressed, it is time to think about the future. What does the world look like in the post-pan environment?

Broadly defined, we see three possible outcomes that hinge on a single determining factor – that being the outlook for inflation. Whether inflation is too hot, too cold, or just right will be key for investors and financial markets over the next three to five years.

Inflation too cold

The “inflation too cold” scenario is one where the risk of deflation, or falling prices, re-emerges. While we have assigned a low probability to this outcome (15%), it is one that cannot be completely discounted given the experience of Japan.

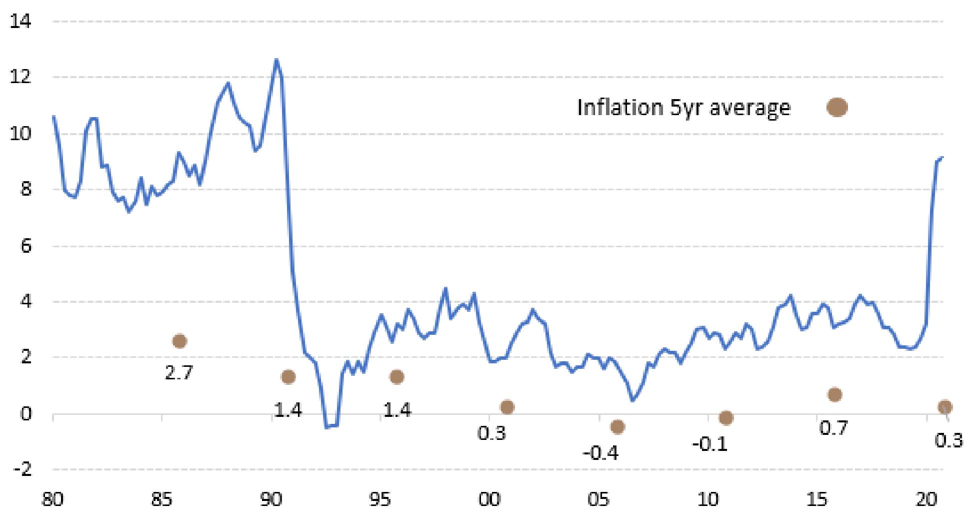
As the chart below shows, money supply growth has accelerated in Japan recently, as it has in many developed economies. As can be seen by looking at the experience with inflation through time, a sharp rise in money supply growth is a necessary, but not a sufficient, condition to spark inflation. Even when money supply was growing at its peak of around 12% in June 1990, inflation in Japan was still averaging around 1.4%.

Japan was one of the earliest adopters of unconventional monetary policy. The Bank of Japan began to buy bonds in 1997 after the property market collapsed in 1990 leaving the economy struggling with low growth, low-interest rates, and low inflation. Despite eleven stimulus packages between 1992 and 2000, Japan couldn’t shake the lower for longer environment. Instead of inflation, the country was left with the largest government debt in the G20, at two-and-a-half times the size of the economy. It has been suffering regular bouts of deflation ever since.

Japan has the largest public debt in the G20

Much is said about Japan’s aging population being a reason for why it is stuck in the lower for longer environment. Interestingly, the share of Japan’s population aged 65 and over in the 1990s was less than what it is in the United States today. In the 1990s, 14% of Japan’s population was aged 65 and over. This compares with 16.5% today in the United States.

Chart 1: Japan M2 Money Supply Growth (yoy%) and Inflation



Source: Bloomberg

Another cause to fear deflation pressure is the potential for excess capacity to emerge in the goods production sector as economies open up and consumer

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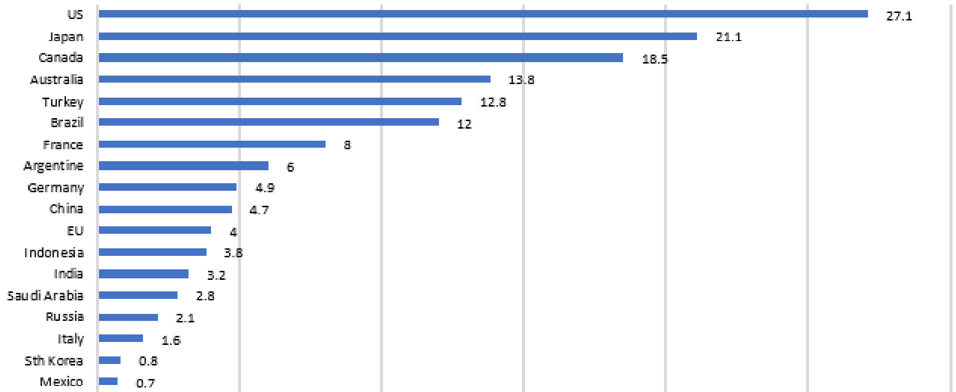
spending rotates toward services. Companies like Peloton have rapidly expanded production to meet demand yet its share price is down 35% from a peak at the start of the year on the expectation that people will go back to working out at gyms instead of at home.

Inflation too hot

The “inflation too hot” scenario is one where the risk of inflation emerges at a much faster pace than expected resulting in significant action from the central bank to contain it. We have assigned a slightly higher probability to this outcome (25%).

The thesis behind the inflation too hot scenario is largely focussed on the size and shape of the pandemic policy response. In total, some $US22 trillion was injected into the global economy. Unlike the response to the Global Financial Crisis (GFC), the heavy lifting this time came from mostly fiscal policy at around $US14 trillion. Moreover, this fiscal spend came predominantly from developed market economies like the United States, Japan, Canada and Australia.

Chart 2: G20 Pandemic fiscal packages (% GDP)



Source: Statistica

Why is this important? Fiscal policy is more direct in creating demand to stimulate consumer spending. Particularly when that fiscal spend comes in the form of direct payments to households. This was the basis for former Australian Treasury Secretary Ken Henry’s call to government to “go big, go household” after the GFC.

Expansionary fiscal policy was adopted in large scale across many developed markets in 2020. The effect can be seen in the sharp rise in household saving rates. Those savings represent pent-up demand and will be spent.

Spending will rotate to services in 2021

The consumption that has occurred so far has been confined to consumer goods given social distancing restrictions are still in place in most countries. It is likely that once those restrictions are eased sometime in the second half of this year, spending will rotate to services.

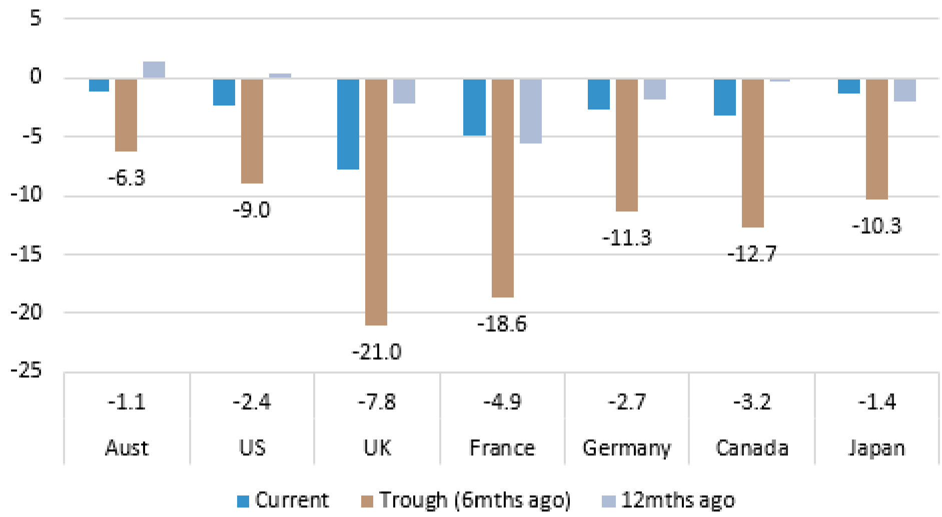
The speed of the correction from the pandemic is a key factor in the inflationist view of the world. The fact that economies have recovered so quickly must suggest that the stimulus has been excessive. Others would argue that without the stimulus, the recovery would have been more painful and drawn-out. What the stimulus did do is maintain productive capacity in the system. Analyst comments were made at the time “how do you go bankrupt in this environment”. The answer is you don’t. Which is the point. Keep business alive long enough to be there at the end to turn the lights back on.

Conceptualising how inflationary the stimulus could be is made more difficult because we are not comparing like with like. We hear dollar figures about how much is being pumped in and only percentage figures about what is being lost due to the shutdowns (GDP growth fell by 6.3% in Australia for example).

An estimated $US25.2 trillion lost in service sector activity in 2020

To address this, consider the following back-of-the-envelope calculation: the size of the global economy is around $US90 trillion with the services sector making up around 56%. Restrictions on the service sector are only now beginning to ease in most countries but assume a conservative estimate of a six-month service sector shut down. At a 56% share, the amount of global GDP lost last year from the service sector alone was $US25.2 trillion. The $US22 trillion in stimulus injected into the global economy doesn't seem so large in comparison.

Chart 3: The snapback economy: GDP growth recovers quickly (%)



Source: Bloomberg

Some may argue that household wealth has actually increased over the last 12 months via higher house prices and higher financial prices and that will also boost consumption. But as our experience with the GFC shows, higher wealth levels don't necessarily translate into higher consumption because the owners of the assets whose prices are rising are not the households that do most of the spending in the economy – the low-to-middle income households. Instead, higher asset prices just lead to higher levels of inequality.

Inflation just right

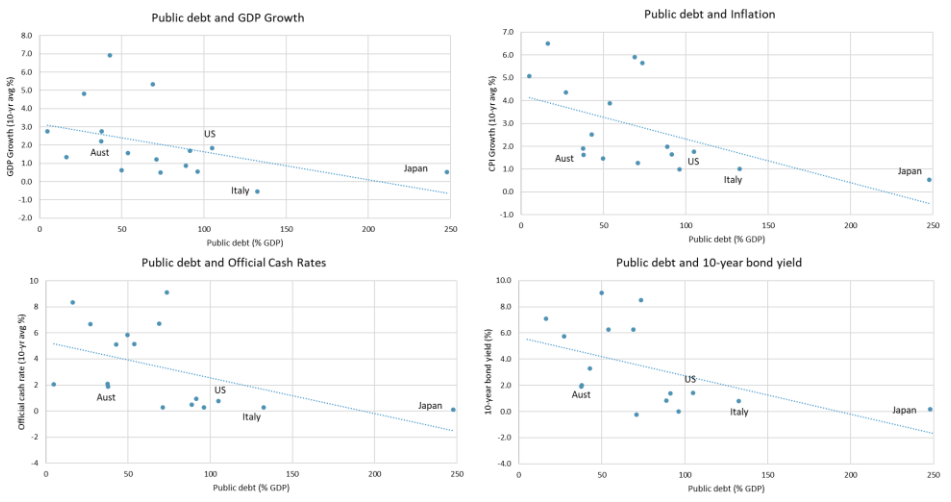
The "inflation just right" scenario is one where the risk of inflation corrects back to pre-pandemic levels leaving the central bank with little need to contain it with excessively restrictive policy. We have assigned our highest probability to this outcome (60%).

The basis for this scenario is that we are, albeit very quickly, returning to the pre-pan world but with a few key differences. First, debt levels are so much higher today than pre-pan. Second, the pace of technological innovation is greater. And third, millennials now outnumber the baby boomer generation (this occurred in 2019). In our view, this points to the same outcome but for different reasons – lower for longer. That is, lower growth, lower interest rates and lower inflation.

As a result of the fiscal policy response to the pandemic, government debt levels are significantly greater. This means the economy is now more sensitive to changes in interest rates like never before.

The charts below show the relationship between high levels of public debt and low GDP growth, low inflation, low official interest rates and low bond yields for the G20 economies. This is evidenced by the trend line in all four charts leaning to the left. Even after excluding the outlier Japan, the picture doesn't change – higher public debt levels are associated with lower growth, lower inflation, lower cash rates and lower bond yields.

Chart 4: High public debt is associated with a lower for longer environment



Source: Bloomberg

Central banks are going out of their way to tell us interest rates will stay low for several years. What they are not telling is they are concerned about what will happen to the economy if they do raise interest rates.

Central banks delay tactics – focus on actual not forecast inflation

Central banks want to delay the move to tighter policy for as long as they can. One way they are doing this is by shifting the focus away from raising interest rates based on forecast inflation to actual inflation. Looking past what this move says about the forecasting abilities of central bank economists (history is littered with policy mistakes on the basis of a forecast that didn't eventuate) the switch to only lifting rates when "actual" inflation begins to rise buys more time. It also allows the structural forces that we have seen in the economy to lift productivity.

Of all the economic variables that are difficult to forecast, productivity is probably at the top of the list. And yet it has the greatest effect on inflation. Higher productivity allows the economy to run faster without generating inflation.

The argument in favour of expecting a lift in productivity in the coming 3-5 years is similar in our view to why productivity spiked in the late 1980s and 1990s – a generational shift. The millennial generation is the largest in history and are now coming into their prime working and spending years.

Millennials - a huge, technologically advanced, cohort will live longer, healthier and more productive lives than past generations

Millennials, who already make up more of the workforce than any other generation, are the first generation of digital natives. Their affinity for technology helps shape how they shop, work and play. They are dedicated to wellness, devoting time and money to exercising and eating right.

In short, this is a huge, technologically advanced, cohort of people that will live longer, healthier and more productive lives than any generation before it.

Think about the lift in productivity that comes from this generation doing what they do today on a daily basis – online shopping, ride sharing, food delivery, voice command tech, cloud computing, mobile banking. It is estimated the cost of acquiring a new customer in the credit card space for a traditional bank ranges from $250 to $1500. The cost of acquiring a digital banking customer is as low as $20. Millennials have no need for bricks and mortar. This not only applies to banking. It applies to shopping and to working and even to recreation. The cost savings in this are significant.

The lift in labour productivity that will come just from millennials making use of existing technology is affecting inflation now. Productivity in the future will benefit from the commercialisation and adoption of newer technologies like artificial intelligence, autonomous vehicles (autonomous ride-hailing will reduce the cost of mobility to one tenth the average cost of a taxi today), augmented reality and virtual reality, the growing use of automation.

So, while we do believe inflation will move up from its current low level (a process that is normal and healthy for a recovery) we don't expect it to break out significantly to the upside.

Implications for investors

We expect the speed of travel for the global economy to slowdown in the second half of this year. As one of our preferred fund manager partners noted this week: "snapback, exaggerated moves in the economy in the near-term shouldn't be confused with a longer-term trend." In other words, a transition is not a trend.

We have seen evidence of the snapback everywhere – economic growth in Australia rose from -6.3% in June 2020 to -1.1% by December; our unemployment rate fell from 7.0% in October last year to 5.8% in February; the household saving rate has fallen from 22% in June to 12% currently.

The snapback is not just an Australian phenomenon. It is global and reflects the fact that the global recession was not caused by anything fundamental. Economies are snapping back to life because the event that caused the dislocation is being addressed and there are no underlying structural problems that prohibit the switch being turned back on.

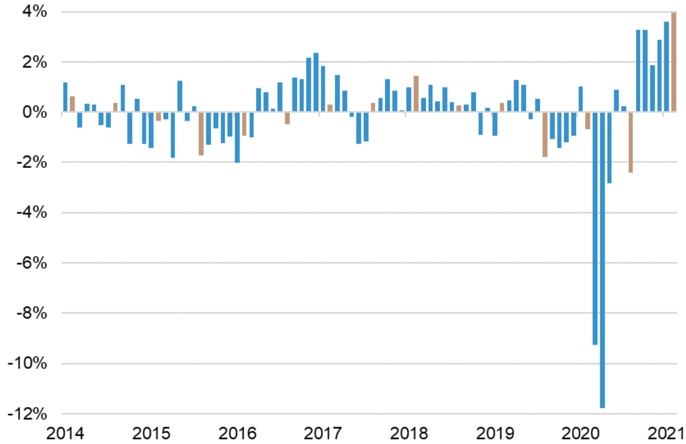
A transition is not a trend

The implication of a snapback is that it is a transition – it is not a trend. By next year, we will see more normal rates of growth in employment, spending, and inflation.

In our view, we assign the highest probability to a post-pan environment where growth remains supported by a still accommodative central bank; where inflation pressures remain contained by higher levels of productivity; and where interest rates remain low. The accommodative central bank policy will be balanced by a tightening of fiscal policy. Government debt levels will be high and a return to frugal policy management will mean growth, and outsized inflation pressure, will be contained.

A more stable economic environment will be supportive for companies and equity returns because uncertainty will be lower. We are already seeing this playout in a rise in merger and acquisition activity. In this environment we continue to like growth biased equity styles, small cap funds, private debt, private equity and unlisted infrastructure. We believe the rotation to value-styles of equity investing is part of the transition and not part of the trend.

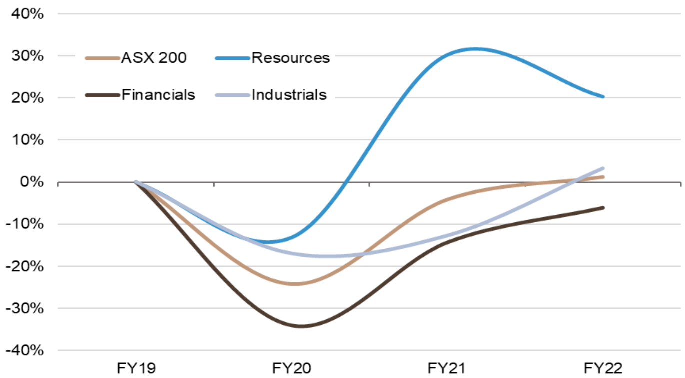
Chart 5: Strongest earnings season in several years – ASX 200 earnings revisions



Source: Bloomberg

February's half year reporting season was the strongest in several years, as illustrated by the high level of earnings upgrades to consensus forecasts through the month and confirming a V-shaped recovery in profits across the market. Historically, it has been unusual to see large earnings upgrades through reporting seasons (as illustrated by the brown bars in the chart), though estimates were upgraded by 4% through the month.

Chart 6: Sharp recovery – Cumulative EPS growth by sector



Source: UBS

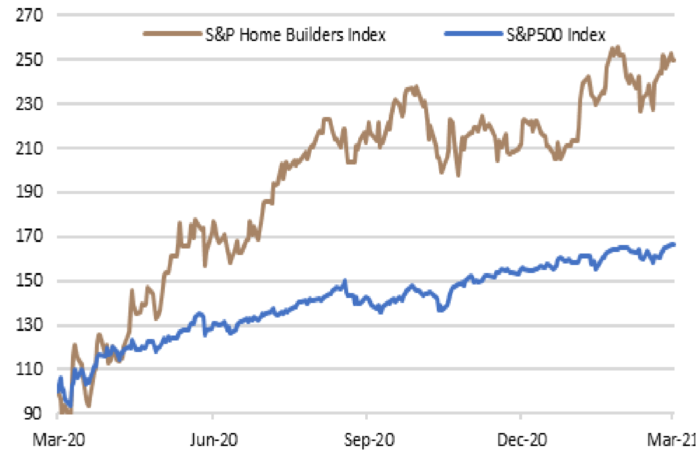
As a consequence, the Australian market is now anticipated to fully recover the earnings decline of FY20 by FY22. Resources earnings are expected to show a large bounce back this year, aided by high commodity prices, while industrials and financials will be the key driver next year.

Chart 7: Dividends returning – ASX 200 forward dividend payout ratio

Source: Bloomberg

Higher than forecast dividends were a feature of reporting season and this trend is expected to continue over the following 12 months. Dividends had previously suffered large cuts following the onset of the COVID crisis, with many companies electing to conserve capital amid an uncertain outlook. On the back of economies reopening and the vaccine rollout, however, dividends are returning, as illustrated by a rise in the forward payout ratio.

Chart 8: Builders rally ahead of broader market (Index 16/03/20=100)



Source: Bloomberg

Homebuilders started outperforming the broader market late last year as locked-down buyers with access to money sought better living conditions. And they haven't let up since with the S&P homebuilder index surging 19% thus far this year versus a 5.7% rally in the S&P 500.

Even the January reading of the S&P CoreLogic Case-Shiller index, which climbed the most since 2014 in December, is expected to show yet another 10% increase. Pandemic-driven demand for more space, growing millennial need for housing, relatively low interest rates and a limited number of homes for sale are all contributing to higher single-family house prices, which is of course great for builders.

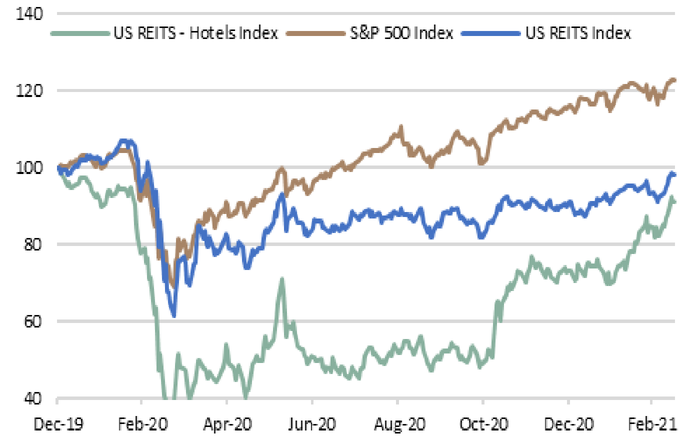
Chart 9: Chinese equities struggle (CSI 300 Index)

Source: Bloomberg

Chinese stocks are trailing U.S. peers this year. Economic data out of China have been underwhelming relative to the U.S. The outlook for the U.S. economy has improved of late on the back of the latest round of fiscal stimulus, while the Fed remains accommodative. Plus, the country's vaccinations are accelerating, which could further enhance prospects for a recovery.

Meanwhile, China's conservative growth target for 2021 and the growing concerns over tighter liquidity are weighing on local equities. Concerns for tech stocks in particular centre around the move up in bond yields globally and clampdowns on some large companies.

Chart 10: US Hotel REITS win on re-opening



Source: Bloomberg

Bloomberg's hotel REITs index plummeted into the end of 2019, when reports of the coronavirus began surfacing, compared with a smaller drop for the broader REIT index.

All that changed on November 9, 2020, also known as "Pfizer Monday", when the first real encouraging vaccine news broke. Since then, the hotels REIT is up 69% compared with 10% for the broad REITs index and 14% for the S&P 500. This is what reopening enthusiasm looks like.

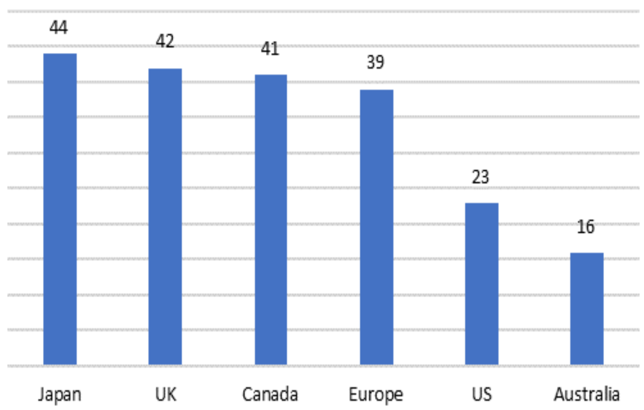
Chart 11: Bond traders anticipate a steep return to rate hikes

Source: Bloomberg

Bond traders are anticipating a steep return to rate hikes in coming years in defiance of what the Fed keeps saying it will do. The market has a long track record of totally mispricing Fed policy, and this looks like another example.

The central bank is committed to allowing inflation to run above 2% and says it will focus on unemployment and wage growth among low-wage workers, probably the last areas of the labor market to pick up. What it adds up to is lower rates for longer.

Chart 12: **Share of central bank bond ownership (% outstanding)**



Source: Bloomberg

The Bank of Canada is signalling a slowing in its bond buying next month – making it the first major central bank to do so. It's not a cause for concern - there are reasons behind the move. The Bank of Canada has already tapered weekly purchases to a minimum of C$4b per week as it brushes up against an ownership problem - purchases are now over 40% of sovereign bonds outstanding. Stimulus will still be injected, just the rapid 4-fold run-up in its balance sheet since last March is no longer warranted. Australia and the US still have some way to go before this become a problem, particularly given the surge in supply will act as a balance.

Chart 13: Global stock of negative yielding bonds ($tn)

Source: Bloomberg

There is one positive side-effect of the recent rise in global bond yields, the stock of bonds with a negative yield is now $4 trillion less.

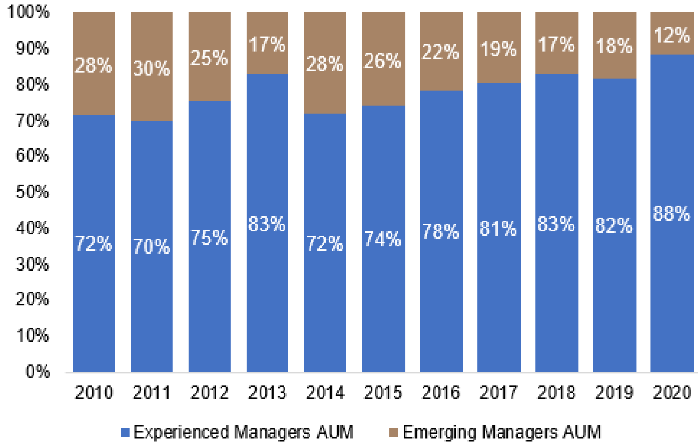
Bond markets are one of the most inefficient markets in the world because there are a large number of participants who have to buy bonds for reasons other than profit maximisation. Insurance companies and defined-benefit pension plans are such examples where their priority is to match liabilities not to earn a profit. It is mostly these market participants that have driven some bond yields into negative territory.

With global government bonds now yielding 70-80bpts more, the cost of that matching activity is significantly cheaper.

Asset Class View

Alternatives

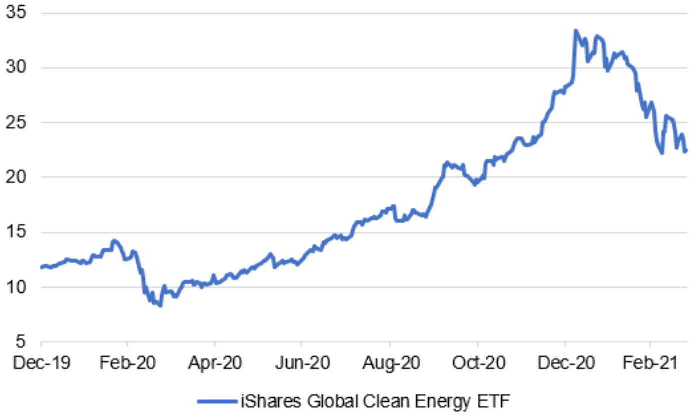
Chart 14: Experience pays in private capital fund raising



Source: Pitchbook

Private market investors continued the trend of allocating greater amounts of capital to top tier experienced fund managers in 2020. The proportion of assets under management (AUM) with emerging managers, those classified as having raised three funds or less, has fallen from 28% in 2014 to just 12% in 2020. With rising numbers of new fund managers entering the private markets space veteran investors like Howard Marks have commented that it is increasingly important to invest alongside experienced managers, harnessing a skill premium, who can consistently produce top quartile returns for investors.

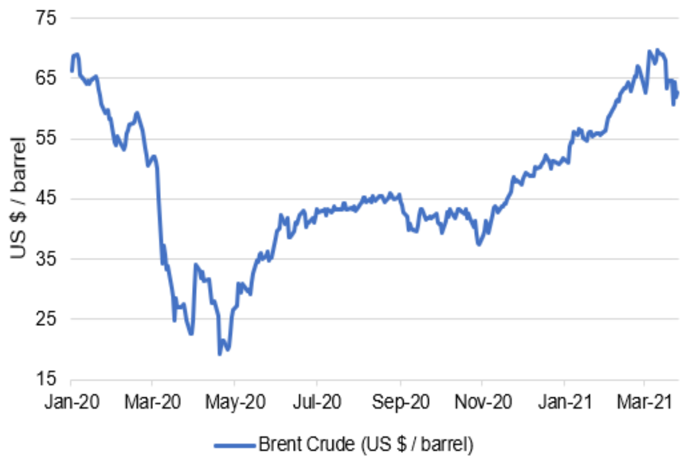
Chart 15: Clean Energy stocks fall from record highs



Source: Bloomberg

The iShares Global Clean Energy ETF is down 32% from its record high price posted on 7th January 2021. Investor profit taking and rising interest rates have impacted valuations on many renewable energy companies. Prices are now trading close to levels last seen in November 2020 when the Biden election win and commitments from big nations like China and Japan to Net Zero targets provided a tailwind for the industry. Recent announcements from the Biden administration proposing $3 trillion in spending focused on infrastructure and clean energy will be positive for the industry going forward.

Chart 16: Oil prices pullback following strong year to date rise



Source: Bloomberg

The recovery in oil markets has been faster than many had initially expected as activity around the world continues to pick-up post lockdowns. Year to date Brent Crude oil is up over 20% as OPEC members continue to hold supply cuts in place for some time. Despite Russian attempts to influence the market by opposing this decision many view the recent pullback in prices as a function of financial flows rather than a substantial change in supply vs. demand balances. Citi see quarterly declines in supply throughout 2021 leading to prices trading well above $70 later in the year.

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