ESCALA
PARTNERS

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MONTHLY AGENDA - ARE WE THERE YET?

Are we there yet?

The great debate among economists and financial analysts right now is – Inflation: transitory or not? Looking at the news and markets lately one could be mistaken for thinking the debate is over with the negative being the victors. Inflation, it would seem, is here to stay.

We take a contrary view or rather believe it is too early to tell if the inflation pressure we are seeing currently will persist to the same extent next year. In our view, the transitory forces are still being played out. In terms of recovering from the COVID-induced dislocation, we are not there yet.

The biggest demand surge since World War II

When we are thinking about whether inflation will be transitory or not we need to think about what is causing the pressure in the first place. It seems there are two main drivers:

1) the surge in consumer goods demand as lockdown restrictions are eased, and

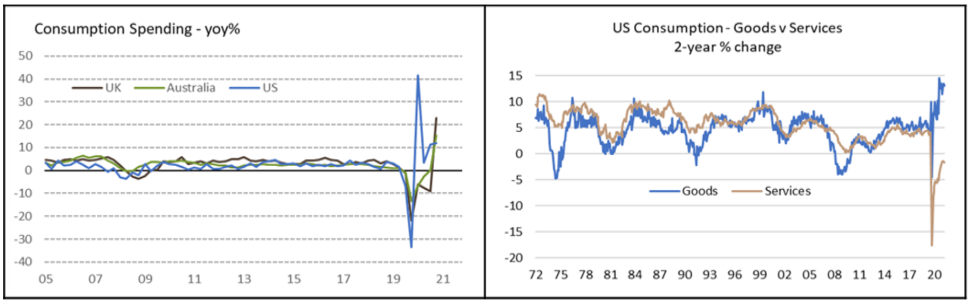
2) the shortage in energy.

There are of course second round price pressures that are feeding through into other prices like commodities and wages.

Most of the price pressure in the US and Australia are being driven by the surge in consumer demand – spending the COVID stimulus packages. As the chart below shows, consumers in the US and Australia have been among the largest responders to the stimulus of any other country in the world.

This is not too surprising given the fiscal stimulus packages in the US and Australia were among the largest in the world. In Europe consumers are more conservative. The price pressure we are seeing there is mostly coming from higher energy prices.

Chart 1: The biggest stimulus drives the biggest surge in goods demand



Source: Bloomberg

In our view the transitory argument for inflation cannot be discounted yet. It is still valid because the drivers of that inflation are themselves transitory and are in fact still transitioning. The consumer spending growth we are seeing in Australia and the US currently, at six to seven times the historical average, is not sustainable. Within consumption, the rampant spending on goods versus services will also correct as lockdown restrictions ease and we spend on services, like travel and tourism again.

The biggest supply collapse the world has ever seen

Balanced against the biggest demand surge since World War II, caused by the COVID reopening, was the biggest supply collapse the world has ever seen, caused by the COVID lockdowns. Supply and demand have been taken to such opposite extremes it is no wonder we are seeing pressure on the supply chain and production bottlenecks.

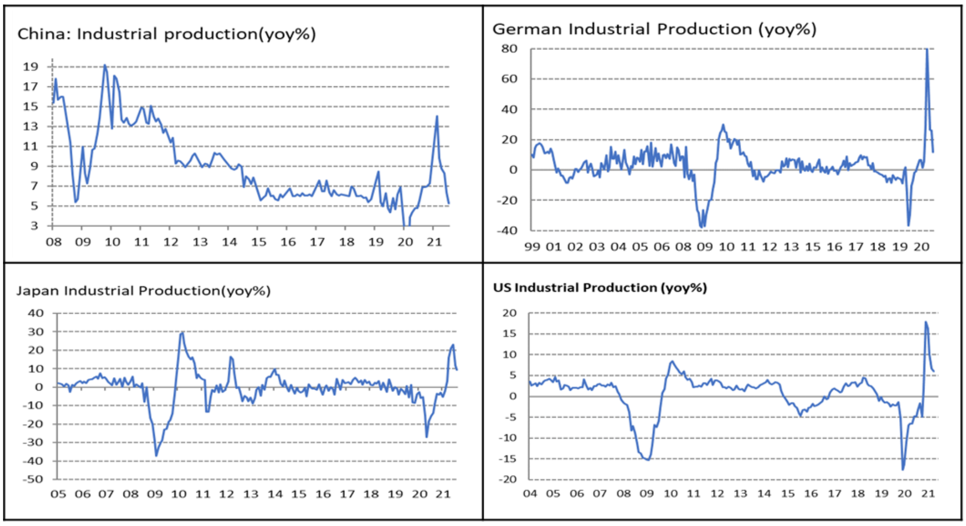
The largest manufacturers of the world – China, the US, Japan and Germany – have been scrambling to meet the demand (chart 2). Industrial production has surged. At one point in Germany it was growing at 80%! Growth has since declined across the board but, with the exception of China, it is still above average rates.

Both of these events, on the supply and demand side, have been far outside the range of previous experience, and therefore impossible to capture in economic models. Unless we believe something fundamental to the economy has changed in the past 20 months, these data points are spurious and have little informational content.

The 12% growth in US consumer spending is as meaningless as the 13% unemployment rate we saw last year.

That is not to say the 12% growth in US consumer spending is as meaningless as the 13% unemployment rate we saw in the US last year but extrapolating these growth rates into the future should be treated with some caution.

Chart 2: The big-4 manufacturers responsible for almost 60% global production



Source: Bloomberg

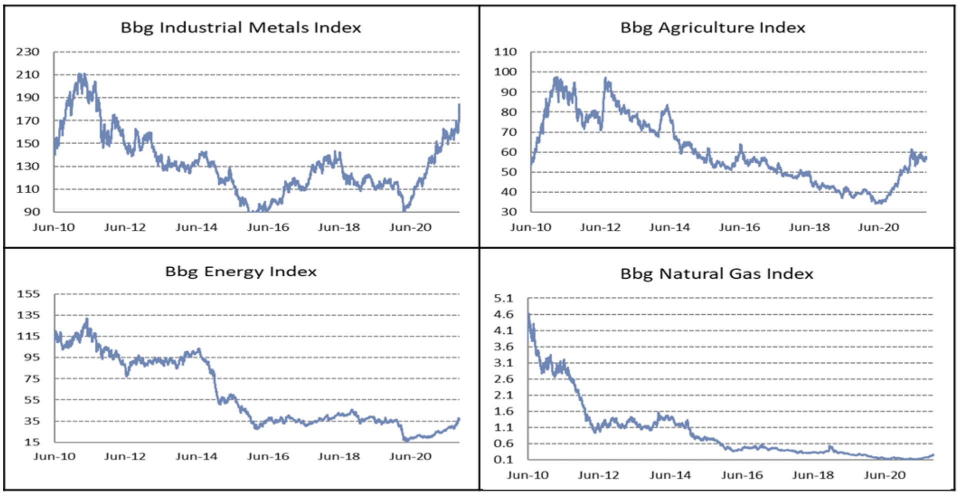
The labour market is still dislocated

Nobody can predict with confidence when supply and demand will come back into balance and the timing will differ for different markets. In the meantime, the imbalance has spilled over into other markets such as commodities and latterly the labour market.

We can see the spill-over of excess demand into commodities in chart 3. Two points are worth making here. First, the upward pressure in prices across all groups, with the exception of natural gas, began in June last year. Agriculture, it seems, has already started to plateau and in fact some commodities within agriculture have begun to correct down. Corn for example is down by 30% since peaking in July, soybeans are down by 26% since peaking in May and cotton is down 6%. Wheat and sugar are still rising. The important point to note, however, is that market mechanisms have not been permanently paralysed or changed by COVID.

The second point to note is that all of the subsectors are still well within historical norms. Indeed, the most sensitive subindex to economic growth is energy. This subindex is made up of crude oil, heating oil, unleaded gasoline and natural gas. It has the highest beta to US consumption of any of the subsectors. And yet it is still well down from its highs in 2012-14. A time, incidentally, when US inflation was tracking between 1 and 2%.

Chart 3: Bloomberg sub-indexes for commodities



Source: Bloomberg

The last market to adjust will be the labour market. The slow correction in the labour supply in the US is possibly due to the type of COVID policy response provided to workers. In Australia our policy response for the job market was to ensure people remained connected to their job (via JobKeeper) so the search time for a new one was reduced on reopening.

The connection between workers and jobs wasn't maintained in the US policy response. Workers were separated from their job in lockdown and were paid an additional unemployment benefit. Now coming out of lockdown those workers need to re-establish that connection with an employer. This will take time, particularly given there are lingering Delta concerns. A comfortable savings account also means there is no urgency. Importantly, however, the pandemic did not permanently shrink the labour force. The employment rate for workers in the 25-54 age bracket, that is currently 2.4% below pre-pandemic levels, will rise back easing labour supply issues and therefore wage cost pressures.

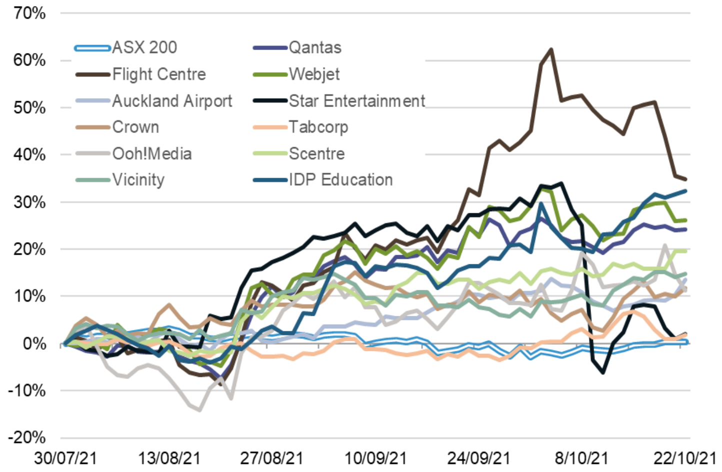
What are the investment implications?

Markets have a tendency to adjust. Some markets adjust faster than others. Some markets may even over-adjust and instead of talking about inflation next year we could be talking about deflation again.

Supporting the case for deflation is the trend that received the largest turbo boost during the pandemic - technology. There are few if any industries that are not being disrupted by technology – from the most traditional like agriculture to the most labour intensive like hospitality. Technology is helping to address some of the biggest labour shortage issues that these industries are dealing with currently. Hotels are experimenting with fully contactless experiences with digital check-in and check-out, mobile keys, a digital concierge service, branded room service via "ghost kitchens", and robotic room service delivery. In agriculture, agri-bots and harvesting machines are replacing migrant fruit pickers who have been locked out due to border closures. The investment in these technologies means there is no going back. What will then happen when borders re-open and migrant workers return?

We are not dismissing the immediate threat of inflation. Our portfolios are positioned to benefit from a rising inflation environment with allocations to global real estate, property and infrastructure and an underweight to fixed income. Our view is simply that it is too early to say that the inflation pressure we are seeing will not ease in the first half of 2022. This therefore means we are unlikely to see an as aggressive rate hike cycle from the central banks that markets currently imply.

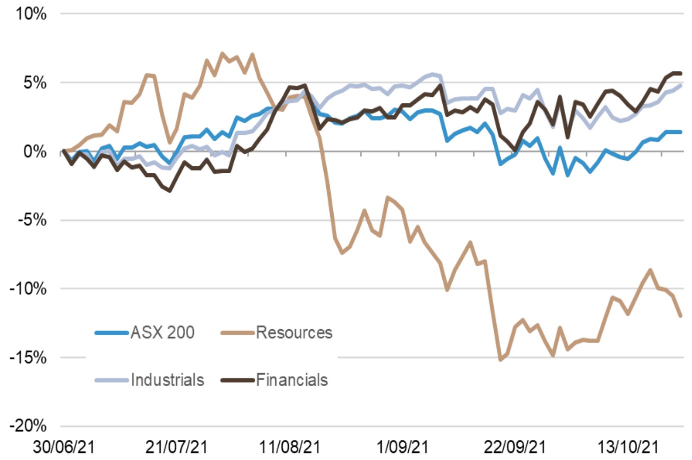
Chart 4: Re-opening stocks rally ahead of lockdowns ending



Source: Bloomberg

While Sydney and Melbourne's lockdowns have only recently lifted, a basket of stocks leveraged to the reopening of Australia's two most populous states had already rallied well ahead of these dates as Australia caught up on its vaccination coverage. Across a range of stocks exposed to travel, leisure, retail, gaming and education, the median performance since July was around 14% the relatively flat return of the benchmark ASX 200 Index.

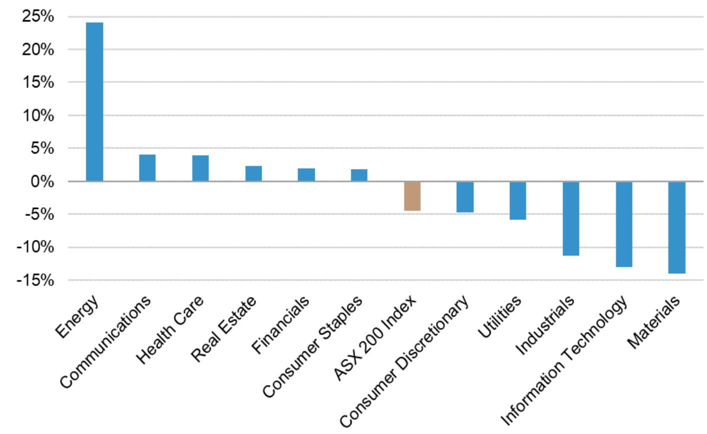
Chart 5: Iron ore a drag on the market



Source: Bloomberg

Despite strength in oil and base metals prices over recent months, the Australian resource index has fallen more than 15% from its August peak and hence resulted in a significant drag on the broader index's performance. With iron ore experiencing a sharp correction in this time, this highlights the sector's reliance on this one commodity, which is the primary source of earnings for BHP, Rio Tinto and Fortescue.

Chart 6: Mixed earnings revisions in the last quarter



Source: Bloomberg

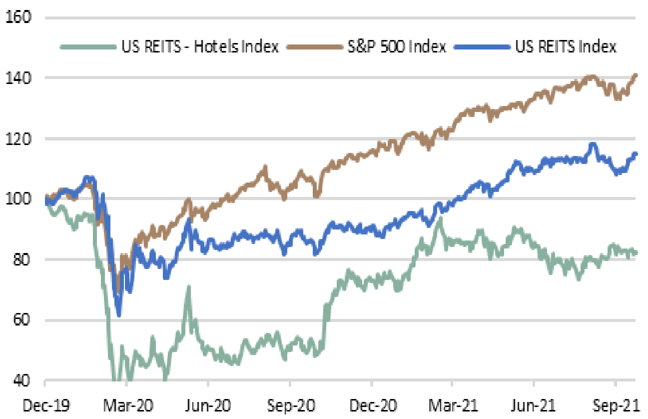
Broad-based positive earnings revisions have faded in the last quarter, with the impact of lockdowns and the collapse in the iron ore price leading to softer earnings for the ASX 200. However, not all sectors have been impacted, with around half of all sectors still recording upgrades, led by significant upgrades in energy stocks.

Chart 7: Chinese equities still struggling (CSI 300 Index)

Source: Bloomberg

While Chinese equities is still the only market to be in the red on a rolling 12-month basis but there are a few reasons to be slightly more optimistic. There's a growing consensus that President Xi's effort to clamp down on dominant industry players has turned China's beaten-down offshore stocks into bargains. Certainly China's -8% 12-month performance looks cheap relative to the +31% gain for the US S&P500. There is also a suggestion that President Xi may scale back China's economic overhaul as the masses feel the pain. Finally, Evergrande has avoided a default on its USD bond paying $83.5 million of interest which had been due on Sept. 23.

Chart 8: Still looking for a re-opening trade?



Source: Bloomberg

It may not be too late to get onto the re-opening bandwagon. As dormant travel demand begins to heat up, and international travel restrictions ease, hotel REITs provide an opportunity to play the economic rebound.

Bloomberg's hotel REITs index is still down 18% since the end of 2019, when reports of the coronavirus began surfacing, compared with a rise of more than 15% for the broader REIT index and a 40% gain for the S&P 500.

The gap between the hotel and broader REIT index did almost close in March this year but the gap subsequently widened as the Delta variant took hold from around May.

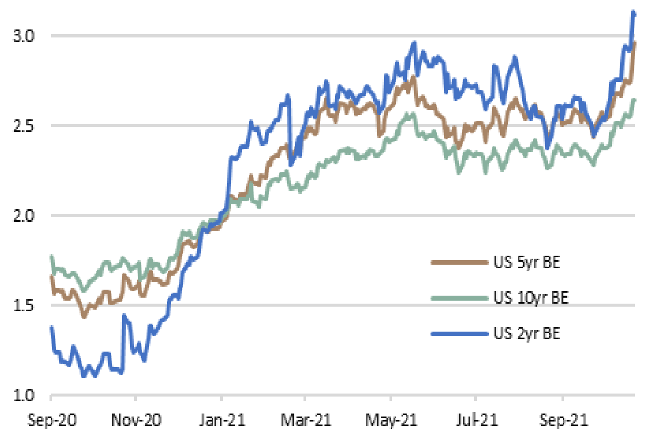
Chart 9: Look whose back – European banks feeling unloved no more

Source: Bloomberg

Rising bond yields and the rotation toward value have provided a crumb of comfort to European bank stocks. Finally, the sector is back above its pre-pandemic level.

European banks stocks have been the best performers on the Stoxx 600 Index this year with a 37% rally. Performance was helped by last month's removal of regulatory restrictions on dividend payments and share buybacks. As the dividend ban ends, European banks will return to having higher dividend yields than their U.S. peers.

Chart 10: Market based inflation expectations rising (%)



Source: Bloomberg

Five-year break-evens have recently pushed out to their highest levels since 2005.

Investors are keen to protect themselves against the future inflation. Breakeven inflation (measured by the difference between nominal and real bond yields) has risen at the 2, 5 and 10 year part of the yield curve. This is occurring even as investors ramp up their expectations that the Federal Reserve will hike sooner and faster in order to lean against the risk that the pace of consumer price gains will be "persistent".

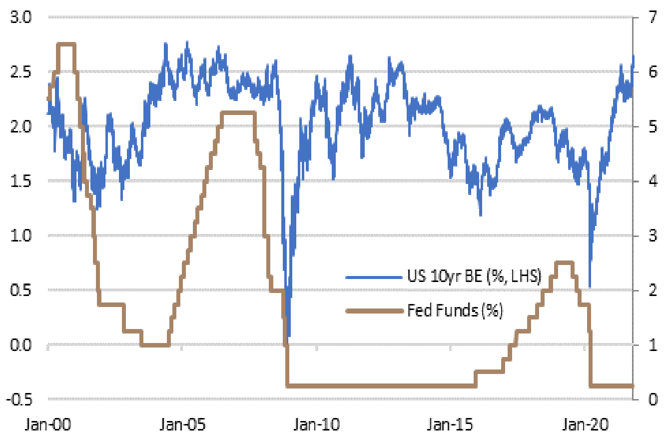
Chart 11: China high yield bonds looking cheap (%)

Source: Bloomberg

Chinese dollar high yield bond yields have recovered somewhat from their highs as Chinese policymakers have argued they "can contain the Evergrande risk," in part by easing policy in the real estate sector. Also giving the market a boost was a report that China Evergrande will pay $83.5 million of bond interest which had been due on Sept. 23.

Financial markets have mostly looked past earlier fears of a Lehman-style crisis as defaults among some of the most-indebted developers have so far failed to induce unmanageable systemic risk. Meanwhile, valuations in Chinese high yield are among the cheapest globally.

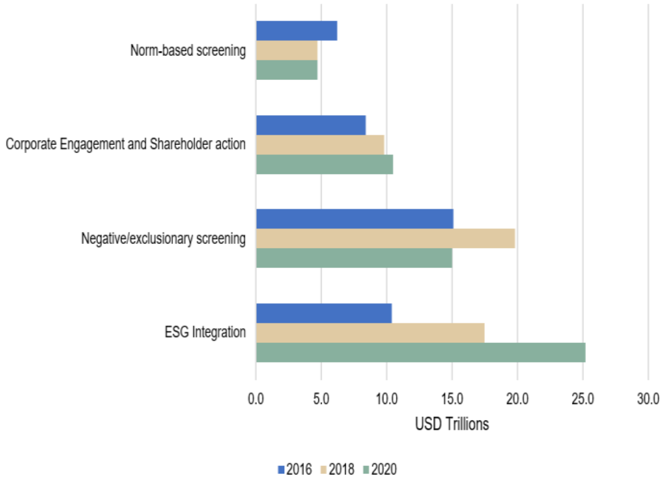
Chart 12: Higher inflation expectations don't necessarily mean immediate rate hikes



Source: Bloomberg

While it can be unsettling to see market-based inflation expectations rise so quickly, the move shouldn't in itself be a sign of a looming rate hike cycle. Admittedly the level of inflation expectations are higher today but the move up in 2009 was more dramatic. Breakeven inflation then hovered around elevated levels for six years before the Fed began to raise rates in December 2015.

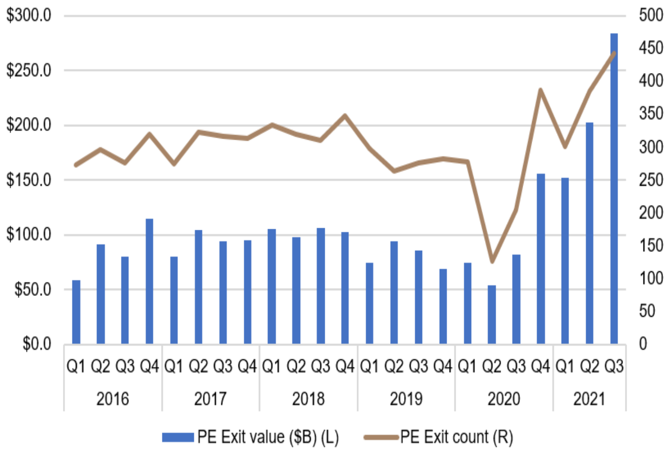
Chart 13: Global Growth of Sustainable Investment Strategies 2016-2020



Source: Goldman Sachs

Global sustainability/responsible investment strategies have seen strong growth over recent years and include: Socially Responsible Investing (SRI), Impact Investing, ESG Investing, Sustainable Investing, Triple Bottom Line and Corporate Social Responsibility (CSR). It is estimated global sustainability strategies represent $US35 trillion in size. The sector was initially dominated by exclusion lists and the divestment movement. More recently, integration – where ESG risks are incorporated into funds' broader mandates – is now the clear leader. ESG investing has particularly resonated with large global institutions– pension funds, insurance companies and sovereign wealth funds many of which have announced significant increases to their investment in ESG-related strategies. Similarly, Australian and New Zealand super funds are taking a leadership role in establishing ESG at the core of their investment strategies.

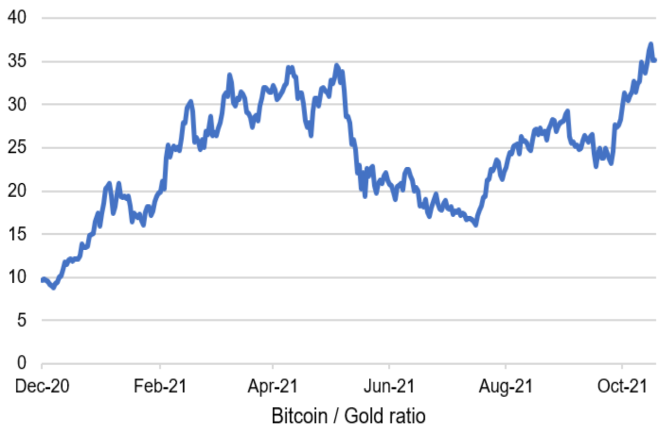
Chart 14: Private equity exit activity breaks records



Source: Pitchbook

Private Equity (PE) exit activity continues to break records with total exit activity surging passed long term average levels for the fourth straight quarter. Total value of PE exit activity year to date is already above $US630 billion, which is 50% higher than the previous record full year total value set in 2018 of $US412 billion. PE managers are seeking to capitalise on the spread between public and private market multiples whilst corporate balance sheets are sitting on record cash levels and looking for suitable takeover targets to deploy this cash.

Chart 15: Investors rotate to bitcoin as inflation hedge



Source: Bloomberg

The ratio of bitcoin to gold price has surged to over 35 in recent weeks with some commentators suggesting institutional investors are now seeing the digital currency as a preferred inflation hedge over gold. Recent developments with the launch of the first US listed bitcoin ETF and comments from the Federal Reserve indicating they won't follow China in banning bitcoin have helped ease investor concerns over the relatively young asset class. Sky high volatility however continues to accompany bitcoin with average weekly volatility 6 times that of gold, acting as a sign of caution for investors considering an allocation to the cryptocurrency.

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