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INVESTMENT REVIEW

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QUARTERLY INVESTMENT REVIEW

Markets continued to move ahead in the second quarter as vaccinations were rolled out, allowing lockdowns to be eased. The vaccination process is most advanced in the US, with Europe a couple of months behind, and the Emerging Markets only really starting their programs now. Nonetheless the stock market recovery of the last year seems incredible against a background where the EU suffered its worst recession since the 1930's, the world has seen the first rise in poverty for twenty years, and millions of families have seen their prospects and financial situation dashed. The exuberant financial performance has come on the back of the huge double barrelled fiscal and monetary response by governments and central banks, which in turn has led to the question of when these support operations will stop, and whether they will trigger inflation.

The policy response to Covid was extraordinarily aggressive. The fiscal response in the first three months was equal to that of the previous five recessions in the US. US monetary policy produced more QE in six weeks than the total of the 2009-2018 period following the Financial Crisis of 2008. This has led to an abrupt recovery, but more puzzling is this unprecedented stimulus has continued even when the recovery is fully evident. The Fed still buys $40bn of mortgages a month even though there is now a housing shortage. They have said that they are not thinking of reducing their bond purchases of $120bn a month, and do not expect to raise interest rates till 2023 despite the booming economy. The strongest economic recovery since 1945 is being met with the easiest financial conditions on record. At 25% of GDP the recently announced programs of President Biden are greater than Lyndon Johnson's Great Society programs of the 1960's. It suggests that the authorities have some doubt as to how well economies would manage if these supports were removed. While the recovery allows the private economy to pick up, there is a big gap to fill. The setbacks and uncertainty caused by the variant strains of Covid also make full unwinding of the lockdowns more complicated. This makes the authorities' task of judging how and when to withdraw their stimulus much harder.

Will this stimulus translate into higher inflation? Inevitably short term inflation will be higher because of base effects and the effects of the rush of demand caused by economies' reopening and supply disruption caused by lockdown, but much of this will be transitory. Will there be more persistent inflation? The pandemic has closed many businesses which reduces supply and gives the survivors greater pricing power. President Biden has announced plans to boost labour union participation and increase regulation, both of which are inflationary. Politically there is pressure for the lowest end wages to rise, not fall, and to reduce the inequality in the economy, and this agenda is reinforced by social media, which has more power than any trade union. Elections, at least in the West, are being determined by blue collar voters in rural and rust belt communities, and these voters are demanding higher wages and pensions, following years of stagnation. Internationally a major driver of disinflation over the past few decades has been globalisation, particularly China taking over large parts of the manufacturing sector and producing goods much cheaper thanks to lower labour costs, and less regard for health and safety measures. The deterioration of relations between China and the West threatens this disinflationary trend. In particular environmental concerns over China's production processes are no longer being ignored. In effect the West outsourced many of their bad practices and pollution to Asia. Largely due to pressure from the millennial generation toxic production is no longer acceptable in the West, regardless of where the factory is located. China announced the closure of 13% of its steel capacity, and similar actions will probably take place in high emission industries like glass, cement, polysilicon and aluminium. This will remove the lowest priced production that China has been providing for the last thirty years and is therefore another inflationary pressure. Companies that exploit the work force either through pay or conditions are also starting to be boycotted. Blockchain allows transparency in production processes all the way to the source and this is changing behaviour. While welcome on humanitarian grounds, it is leading to a structurally higher cost base. Food prices have also risen considerably, an area where demand was not particularly affected by lockdown. For example in the year to 31st May pork prices (important in China) rose 106%, corn by 105%, soybeans by 86% coffee by 67%, sugar by 61%, and wheat by 31%. If this trend continues it will feed through to wage rises. An early sign of this was that some large companies like McDonalds, Chipotle, Bank of America and Under Armour all raised their wages by well over 10% during the quarter. Inflation becoming more persistent is not a certainty yet but the three big disinflationary drivers of the last decade have been globalisation, deregulation and technology, and the first two are going into reverse. There are more upward pressures on prices than at any time since the collapse of the Berlin Wall. The question that will really matter is at what interest rate will the long end of the bond market stabilise? The bond market will set the yield for ten and thirty year money based on its expectations of what future growth and inflation will be. If the US 10-year rate settles at around 3% then the stock market will probably digest that without too much alarm. However if the rate pushes towards 4-5% then many assets will look mispriced. The default setting of many investors having approximately half their assets in bonds and half in high quality growth stocks, which has prevailed for the last twenty years, would be undermined and all markets would see a major upheaval as investors reallocate. For example the $16tn of negative yielding bonds would look grossly mispriced.

So what does an investor do? The bond market has been stripped bare of value, and inflation is poison for bonds. This has pushed investors into stocks, but after the huge rally of the last year equity valuations are correspondingly higher. Nonetheless many companies reported exceptional results for the first quarter which justifies their high ratings. Some were astounding. Amazon’s sales were 44% higher than the previous year; Microsoft produced $18 billion of free cash flow in the quarter. The mega cap technology companies are formidable, but they face increased regulation and taxation, and a much more aggressive political environment. For more pedestrian growth companies much will depend on how inflation plays out, as rising inflation could lead to them being de-rated. The better prospects could be in value companies which have been ignored by the market since the 2008 crisis. An obvious example would be the commodity sector. Environmental concerns are front and centre for politicians and the public now. Transitioning economies away from carbon fuels to renewable sources will be a multi-year story, not just a couple of quarters. It is also metal intensive. Commodities are becoming one of the biggest beneficiaries of ESG, which is generating demand and severely curtailing supply. Copper and several other metals are essential for the electrification of the energy grid. The Manhattan Institute estimates that a 100MW wind farm requires 30,000 tons of iron ore, 50,000 tons of concrete, and 900 tons of non-recyclable plastics; while a 100MW solar plant requires cement, steel, aluminium and glass 150% greater than the wind farm. There has been little investment in new mines recently, which take several years to bring to production. Many mines of critical metals are in countries where resource nationalism is rising. For those companies whose mines are in friendly jurisdictions the prospects look good. Equally as miners improve their ESG scores they become investable to the big pools of capital that need to be seen to be ESG compliant. Elsewhere if the recovery and the inflation pressures continue value sectors such as financials and retailers can do well. As the recovery broadens out global investors are likely to reduce their US exposure somewhat, in favour of Europe, Japan and the Emerging Markets. However the value trade needs to be highly selective given the heavy debt many value companies carry, and the continuing challenges posed by technology on old business models. There will be a premium on stock picking.

Since the Covid crisis financial markets have become heavily dependent on support from Central Banks. A lot depends on the Fed continuing to wave its wand. A concern is that the eventual economic outcome is a weak recovery after all the stimulus packages fade. This is a possible message that bond markets are signalling. The huge debt that has been wracked up, with little discussion about how to pay for it, combined with the prospect of rising taxes and wages would make a growth scare alarming. Moreover if inflation remains stubborn through the second half of the year the Fed's credibility will be increasingly tested. Active stock picking remains crucial, but the best areas appear to be the 'digital and the dirty'; i.e. focusing on the companies generating the transformational technological revolution that we are undergoing, and the commodities that will be needed to make it possible.