

Reflections & Insights

QUARTER FOUR 2021



“Millionaires don’t need astrologers, billionaires do.”

–J.P. Morgan

This commentary is authored by GuardCap Asset Management Limited¹

You have to feel some sympathy for the poor souls who make a living trying to predict the future. Not astrologers, but economists and market strategists. The world has never experienced the conditions which have prevailed over the last 18 months and the uncomfortable reality is that nobody knows exactly how things will play out. Generally, forecasting relies on modelling the past to determine a likely and preferably narrow range of outcomes. History isn’t much of a guide at the moment. Most prognostications are about as good as astrological predictions.

Of course, that is a recipe for a rather short review. We don’t actually know what will happen, but instead we can look at what is happening and see if it makes sense to draw any conclusions.

First, the world is getting somewhat back to normal – not everywhere and not with equal vigour. The most powerful stimulus packages are coming to an end and job support schemes are sputtering out. Despite recent disruption from the rise in COVID-19 cases associated with the spread of the Delta variant, the distribution of vaccines and improved COVID-19 treatments give some cause for optimism that the worst of lockdowns is behind us. As things have begun to recover, the strains in the system are becoming apparent. Supply chains are dyspeptic, labour is short in many fields and energy prices have been frisky. The impact of this has been shortages of different sorts in different places, but every country is experiencing some form of indigestion. This has shown up in rising prices, again with varying intensity depending on the country. This phenomenon reflects the biggest boost to demand since the Second World War, set against the largest collapse in supply ever seen. It really is not surprising that there are no computer chips, shipping containers or care workers.

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Rising prices have the commentariat in a proper lather. The talk is of stagflation, a nasty condition which implies high embedded inflation coupled with no growth. This channels the 1970's, a grim decade of economic crisis and bell bottoms. Fortunately, looking at the data on shipping and inventory, the most severe bottlenecks are showing signs of easing. The normal way businesses respond to increasing demand is to increase orders for goods, which of course arrive with a lag. The most likely course of events is that supply and demand for goods comes back into balance at some point – indeed, it is quite possible that businesses will find themselves overstocked, and instead of talking about inflation, we will be worrying instead about an inventory recession.

Labour presents a different question. If the price rises we see become embedded and start to trigger a wage spiral, the risk of stagflation grows. For now, the price of labour is rising and the pain of rising prices generally is being shared between corporations (who are experiencing a margin squeeze), and consumers (for whom price rises represent the same hit to disposable income as a tax increase).

The other imponderable on the inflation front is energy prices. To a large degree, the current squeeze on natural gas prices reflects geopolitics. This has many faces, including the attitude of the US to Iran and the attitude of the EU to Russia, where it has not opened the Nord Stream 2 pipeline. You can argue that this would increase European dependence on Russian gas, which it surely would, but it would solve the immediate problem. Climate change is another issue which is likely to increase volatility in energy prices. First, the growth of non-fossil fuel energy sources has discouraged investment in energy exploration and development; second, increasing reliance on wind, solar and nuclear supply will also increase dependence on less reliable sources of energy (what if there's no wind?) which cannot easily be stored and may need to be supplemented at short notice with fossil fuels. These factors are likely to be among the unintended consequences of addressing the climate issue.

In general, the supply/demand balance has been worsened by the global approach to inventory management. It costs money to hold inventory, so holding as little as possible has been the objective of almost everybody. This has led gas storage capacity to be run down, hospital beds to be cut and inventories of goods to be slashed. None of this was a problem until it was. In looking ahead, one conclusion could

well be that inventory levels need more resilience – meaning more stuff in warehouses, more gas sitting in storage, empty beds in hospitals and so on. If the world follows this reactive but logical path, working capital requirements for everybody will rise and either prices will go up or margins will decrease, most likely a combination of the two. The optimists will point to the ability of technology to manage these processes and argue that the productivity improvements associated with digitisation will more than offset any squeeze.

The conclusion of this disquisition on inflation is that stagflation is not a certainty, and if it does develop, it will be the second half of the decade before it is visible. The alternative construct is that we enter an era of higher inflation than we are used to, but not so high that it becomes problematic, while growth remains positive. This is also the outcome desired by governments everywhere, as they have taken on so much debt that higher inflation removes the sting of repayment more painlessly than a tax rise.

The UK is experiencing the same issues as all other developed countries, but with amplified effects, most likely as a result of Brexit. The lack of planning for the inevitable supply disruption caused by the rupture with Europe has been magnified by the results of COVID-19. The UK also has, as a matter of policy, very lean inventory, whether it be in gas storage or healthcare resources. This has led to more severe shortages in the country than elsewhere, with a more significant inflationary impact.

Putting all this together with the outlook for growth and interest rates is back in the realm of educated guesswork. The likelihood is that short-term interest rates in most countries, but most importantly the US and EU, will remain anchored close to zero in the year ahead. This does not mean that longer-term rates will remain as docile as they have been – indeed, one would expect some rises in rates to reflect the conditions discussed earlier. Nevertheless, these are unlikely to derail the economic recovery which global central banks are trying to engineer. As the economic stimulus of dealing with the pandemic fades, the fiscal thrust from most countries will be much smaller next year than this. This is jargon for saying that there will be a bit of a headwind to growth next year. The risk, already mentioned, of inventory issues and the continuing possibility of further COVID-19 variants means that forecasts for 2022 cannot be made with much confidence. It will probably be alright, and if it isn't, expect further monetary stimulus.

During the last quarter, the development of Xi-ism gained momentum. In China, the private education sector was brutally defenestrated and there were several initiatives which trimmed the sails of the Chinese internet sector. All of this was taken very badly by the stock markets, but its importance lies more in what it tells us about Chinese ambitions. The hostility of US strategy towards China is leading to policies meant to bolster Chinese technological capability in the hardware sector. This is hardly surprising given how technology transfer has become a geopolitical pawn. At the same time, the country is attempting to level up society. An increasing focus on consumption and social wellbeing lies behind the attacks on the education sector and also on the willingness to allow Evergrande, the major property developer, to default on its bonds. Families spend huge sums on additional education for their children and housing costs have been out of control. Some of the measures introduced are political stunts, but they aim to underline the essential nature of the party and the indispensability of Xi himself. It means a greater domestic focus and lessens the likelihood of a Chinese stimulus package of the sort which so helped the global economy after the global financial crisis (GFC).

It seems almost bizarre that 13 years after the GFC, the policies which formed the response then are largely still in place, yet things seem to have changed so dramatically over the last two years. The reality is that we remain in crisis conditions, but the passage of time has inured us to that fact. In the medium term, there is almost no chance of exiting crisis mode – the tools crafted to deal with the pandemic and the GFC can't be uninvented, and they have given policymakers the scope to prevent the economy from hitting the rocks.

If this thinking is correct, the liquidity conditions for risky assets remain positive. It is surprising that the issues which have come to the fore this year have not really caused a market correction of any significance (with the exception of emerging markets), and most strategists are peering anxiously into the murk to see where the trigger for such a setback might be hiding. As set out in this review, there is no shortage of potential triggers, but so far it is eerily quiet. In the past, we have commented on high levels of valuation and other signs of speculation as worrisome, but for now, liquidity dominates.

Over the next few months, we may see some earnings shortfalls as cost increases eat into global margins, and given levels of valuation, there is not much room for disappointment, with some correction unquestionably overdue. Nevertheless, with the interest rate picture reasonably stable, a correction is likely to be seen as a buying opportunity which of itself would limit the extent of any decline. There is always the possibility of something coming out of left field - an 'unknown unknown', but by definition that lies beyond the reach of this review.

Some markets look cheap, including China and the UK, but broader exposure offers protection from the idiosyncrasies of those countries. Bonds are generally unattractive as rates could well rise and premiums for additional risk in most sectors are compressed.

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