ISGAM

Manager's Report

QUARTER TO 30 JUNE 2021

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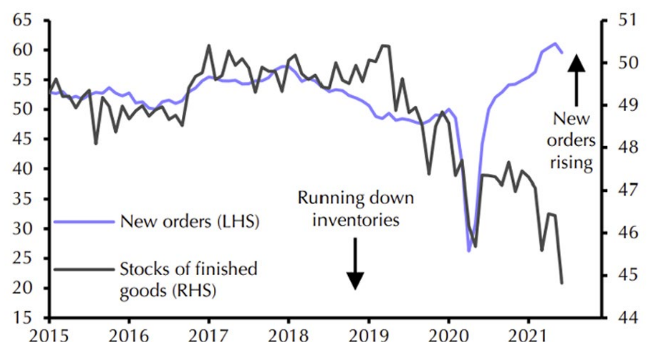
Many trends seen in the first quarter of this year continued in the second quarter. A gradual re-opening of economies, albeit uneven and with setbacks, gave a boost to economic growth and to inflation, providing a positive backdrop for equity and commodity prices, especially in more cyclical areas of the equity market, and a negative one for bond markets, as core bond yields rose from depressed levels.

It is quite a challenge to interpret fully the economic data that are currently being published; both growth and inflation numbers are heavily distorted by the unprecedented collapse in demand caused by COVID lock downs last year. Meanwhile, a shift is happening in consumption demand, away from "stay at home" items, such as IT equipment, streaming media services, home entertainment and improvement, to more traditional leisure, restaurant and travel services. This is colliding with still depressed supply and causing massive price spikes in a variety of items such as rental cars, restaurant meals, semi-conductors, and certain commodities. High risk of COVID infections among crews on container ships, coupled with a lack of available vaccines and viable return journeys for these essential workers, is contributing to bottlenecks in container shipping – the average global benchmark rate for shipping a 40 ft container has risen from under USD 2,000 to close to USD 8,800 over the last year.

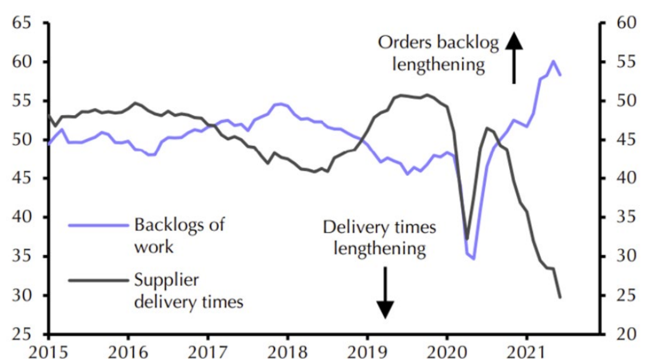
Not all schools have reopened and many lower paid workers in service industries, such as restaurants, retail, healthcare, are therefore not able to return to work, contributing to wage inflation.

Chart 1) Supply bottlenecks: Developed Markets New Orders and Inventories of Finished Goods Indices show a mismatch



Source: Capital Economics

Chart 2) Supply bottlenecks: Developed Markets Backlogs of Work & Suppliers' Delivery Times



Source: Capital Economics

Meanwhile, Central Banks seem to be shifting their frameworks.

For the past few decades Central Banks have set policy in accordance with an implicit or explicit inflation target, which provided a simple and straightforward framework for policy makers to communicate their thinking and for financial markets to anticipate their actions.

This setting of inflation targets was a 1990's response to the stubbornly high inflation of the 1970's and 1980's. In hindsight, this narrow focus on inflation led to monetary policy being too loose in the early 2000's, helping create the housing bubble and resulting 2008 financial crisis. The subsequent need to repair bank and household balance sheets caused a decade of persistent deflation after the GFC. The COVID pandemic and resultant forced interruption of most economic activity, also have made deflation the bigger threat. We now have a situation where all Central Banks of major developed economies are explicitly including other goals in their framework. This coincides with unusual inflation pressures, many of which will be transitory. Both factors put together form a challenge for financial market participants to anticipate Central bank action, and gauge "fair" levels of interest rates. The debate about whether Central Banks are at risk of falling "behind the curve" and whether we face a new era of persistently high inflation is particularly heated right now.

Economists of the "monetarist" school believe that the massive injections of liquidity, coupled with expansionary fiscal policies, will inevitably lead to the inflation genie being let out the bottle. More "Keynesian" economists point to the more temporary nature of most inflationary pressures, and the fact that, due to still depressed bank lending, the velocity of money is not yet fast enough to turn the large supply of money in the system into lasting inflation. The debate will continue to cause bouts of volatility in asset markets from time to time.

The US Federal Reserve has always had a dual mandate: providing price stability as well as full employment.

They have now explicitly stated that they will look through "transient" inflation pressures in order to achieve stable inflation over the medium term, meaning periods of inflation undershooting the target can be followed by temporary overshoots, until the economy is back at full and inclusive employment. With US employment still 7.6 million below its pre-pandemic level, the Fed are probably in no hurry to start raising interest rates, and we expect the first US rate hikes in 2023.

Before that, they will start reducing their Quantitative Easing program, probably towards the end of this year, with a possible announcement at the annual Jackson Hole meeting in August.

Currently the Fed is still buying USD 80 bn of Treasury bonds plus USD 40 bn of Mortgage Backed securities a month. Remarkably, the 10 year US Treasury yield declined this quarter, from a peak of 1.7% at the end of March to 1.35% today.

Meanwhile market estimates of near time inflation have risen: the market implied level of US inflation 5 years from now is 2.55%. But interestingly, the market's perception of 5 year inflation in 5 years time (the so called 5 year / 5 year inflation breakeven rate) has fallen back this quarter, to only 2.15%. The US Fed, looking at these long-term inflation expectations, will interpret these as being "well anchored" at close to their 2% target.

Chart 3) US 5 year inflation expectations (blue line) are higher than longer term inflation expectations (black line)

Source: Bloomberg Finance L.P.

The European Central Bank (ECB), which has always had the singular remit of price stability and tended to interpret this in the tradition of the German Bundesbank's fear of inflation, has now offered a shift in its language – its recent "strategy review" as set out by Christine Lagarde showed a clear break with the Bundesbank tradition.

The ECB has not gone as far as the Fed, but has changed its inflation target from "2% or less" to "2% symmetric average", meaning it will accept temporary overshoots in inflation, much as the Bank of Japan, the Bank of England and the Scandinavian Central Banks are already doing. The ECB will also include combatting Climate Change in its mandate, include Green Bonds in its asset buying program, and demand more disclosure from green bond issuers. Given the considerable slack remaining in the EU labour market, we see EU price pressures as persistently lower than in the US or UK and do not expect the ECB to hike interest rates at any point in the next few years.

The Bank of England meanwhile sounded much more optimistic about the UK growth outlook in its recent meeting and increased its 2021 GDP forecast to 7.2%, with inflation to peak at 2.5% this year and settling back to 2% next year.

They will not raise rates until spare capacity has been eliminated (the Bank's unemployment target is 4.5%), and core inflation has been "comfortably and sustainably" above 2% "for some time".

Recovery should be "unambiguous" before the BoE will contemplate monetary tightening. This is not expected before 2023.

Many countries in the Developing World are still struggling with large outbreaks of COVID, including new variants. Most Developed countries have secured enough vaccines to serve their own populations several times over. The Astra Zeneca vaccine (the only one developed with the explicit goal of it NOT being a money maker but to be affordable for all) has had a manufacturing set back due to a major COVID outbreak in India. The bulk of the Indian production was intended for COVAX – the Worldwide Initiative aimed at equitable distribution of vaccines to developing countries.

So far, COVAX has only shipped about 102 million doses – a far cry from its target to deliver 1.8 bn doses by early 2022. COVAX and the World Health Organization are now looking to China to fill the void and have ordered over half a billion vaccines from China's Sinopharm and Sinovac Biotech. These vaccines apparently have a lower efficacy rate (between 50% and 80%) but can at least slash rates of severe disease and death.

Global growth expectations remain positive for this year and next; clearly many developing economies are far from recovering fully from the pandemic. Until vaccines are widely and fairly available the global economy remains at risk to new variants, bottle necks in the global supply chain, and resulting inflation.

We are watching all trends closely, especially those relating to the direction of interest rates, as these are key to pricing all other asset classes. We still see no value in long dated government bonds, where yields do not compensate for inflation and will inevitably rise over the next few years.

With regards to equities: valuations are not cheap but rising stock prices have been accompanied by large increases in companies' earnings expectations so are actually fair, especially in Europe, the UK and several Emerging markets.

Chart 4) Change in corporate earnings expectations since beginning 2021, per region

Note: Japan and Australia year-end is as per the fiscal date, i.e. ending in March and June, respectively

HISTORICAL PERFORMANCE INDICATIONS AND FINANCIAL MARKET SCENARIOS ARE NOT RELIABLE INDICATORS OF CURRENT OR FUTURE PERFORMANCE.

Last data point: 07/07/2021.

Source: Refinitiv, IBES, Credit Suisse

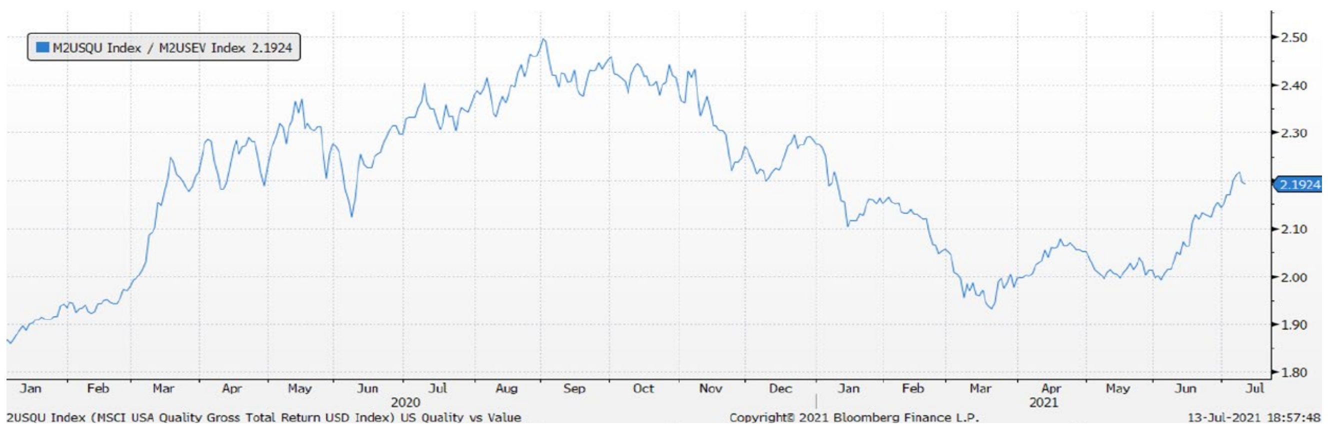
While economists and bond fund managers are very involved in their “Big Inflation” debate, equity market participants have been caught up in a debate of their own – that of “growth” versus “value” stocks.

So called “value” stocks are those of cyclical, economically sensitive companies, mainly in sectors such as energy and materials, financials, consumer cyclicals such as autos, airlines, and some industrials. “Growth” stocks are those of less cyclical companies with high pricing power, steady demand, and expected steady growth in earnings such as can be found in health care, technology, consumer staples sectors. The year 2020 was a year where “growth” stocks outperformed “value” stocks by a wide margin.

This year, the re-opening of economies and increase in bond yields initially caused a nearly complete reversal of that trend and the sectors that outperformed in 2020 underperformed in 2021 and vice versa. The sectors that were most bombed out in 2020, such as airlines, oil companies and banks, saw a revival in their share prices. This revival in “value” stocks lasted from early November 2020 (the FDA approval of the Pfizer vaccine) until the end of the first quarter of this year.

In the most recent quarter, equity price action has been more nuanced and there has been a relative bounce back of high-quality company stock prices compared to more cyclical ones.

Chart 5) US “Quality” stock performance relative to US “Value” stocks, expressed as a ratio (US Quality Sector divided by US Value Sector)



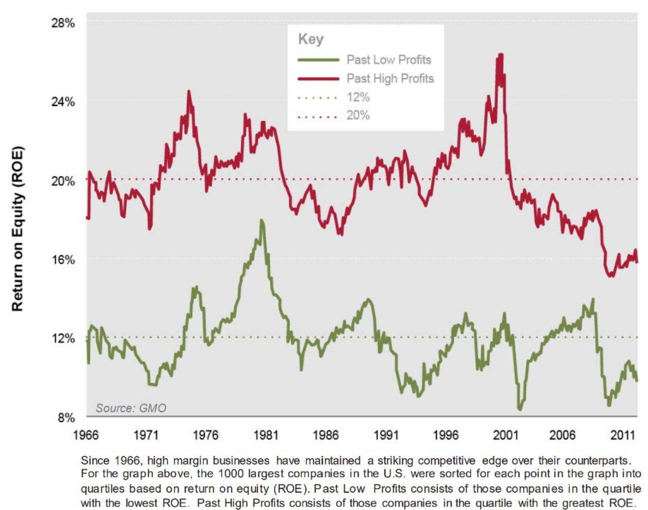
Source: Bloomberg Finance L.P.

We have maintained a healthy balance in equity portfolios between so called “value” and “growth” stocks, but have a natural bias towards quality growth stocks.

Over the many years and cycles that we have been involved in the investment business the most reliable and persistent way to create long term value for clients has proven to be investment in high quality companies run by good managers, providing quality goods or services with high pricing power and high barriers to entry.

These types of companies have stable and persistent profit margins and can reinvest in their business from excess earnings without the need to unduly leverage their balance sheets.

Chart 6) Past profitability of companies is a good predictor of future profitability



Since 1966, high margin businesses have maintained a striking competitive edge over their counterparts. For the graph above, the 1000 largest companies in the U.S. were sorted for each point in the graph into quartiles based on return on equity (ROE). Past Low Profits consists of those companies in the quartile with the lowest ROE. Past High Profits consists of those companies in the quartile with the greatest ROE.

Source: Fundsmith

Over time, returns to shareholders are directly correlated to the return on capital companies generate, and while it is occasionally possible to make an outsized return by investing in a "value" stock at the bottom of the cycle and nimbly selling it at the top, buying and holding stocks of high-quality businesses are a more secure and durable way of producing long term investment returns.

What does all of this mean for our investment strategy, and portfolio positioning?

- Global equities remain the most attractive asset class. Though 10 year bond yields may rise a bit, especially in the US, they will be capped by Central Bank purchases for some time to come. Equity valuations are justified by low interest rates and strong earnings growth expectations. We suspect that inflationary trends evident in the US today are a bit less "transient" than the Fed seems to believe. There is evidence of wage pressures which could lead to medium to longer term inflation in the US being a bit higher than the 2% to which we have become accustomed. Historically, in periods of moderate inflation (up to around 4%) equities are the best asset class to preserve investment capital.
- We are mindful to include some "value" stocks in portfolios but are careful to avoid value traps and maintain a focus on companies and sectors that enjoy secular growth momentum, many of which can be found in the technology, healthcare, communication, and industrial sectors.Companies that will profit from the coming boom in infrastructure investment, and the transition to clean energy, are also firmly on our radar. We maintain a slight overweight to funds in smaller companies in global equity portfolios.
- Alternative asset classes (private Equity, long/short equity strategies, event driven strategies, global real estate) offer appreciation potential and diversification/hedging benefits. Commodity prices have recovered sharply from last year's depressed level but this trend has now largely played out. The Chinese government has actively started to combat rising commodity prices by threatening speculators and unloading government stockpiles.
- In bond portfolios we retain an overweight to High Yield and Emerging market bonds, and underweight duration.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general. We hope you are safe, and well, and keeping in good spirits in these unusual times.

Portfolio Management Team, ISGAM AG

Marianne Rameau ASIP

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