ISGAM

Manager's Report

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After a relatively quiet summer, the third quarter ended in a decidedly "risk off" mood as several global topics are dominating news headlines and coming to the fore of people's worry list, detracting from the ongoing re-opening of public life, and accompanying economic revival.

We will attempt to address these issues, and how they relate to our investment strategy, in this report. They are, in no specific order:

- The recent surge in energy prices, particularly the price of natural gas, especially in Europe
- How these add to already elevated headline inflation numbers
- Whether this will throw the nascent economic recovery off course
- Ongoing supply shortages and distribution bottlenecks as demand surges while economies reopen; in the UK these are aggravated by the effects of Brexit
- The partisan standoff around the imminent debt ceiling in the US (at the time of writing this appears to have been temporarily resolved until later this year)
- A potential default by a highly indebted large property developer in China, and its consequences for the global financial system
- The recent regulatory crackdown by Chinese authorities on certain private companies in the technology, healthcare, and educational sectors
- The effect that "tapering" of monthly bond purchases by the US Federal Reserve, expected to begin towards the end of this year, will have on bond yields and financial markets

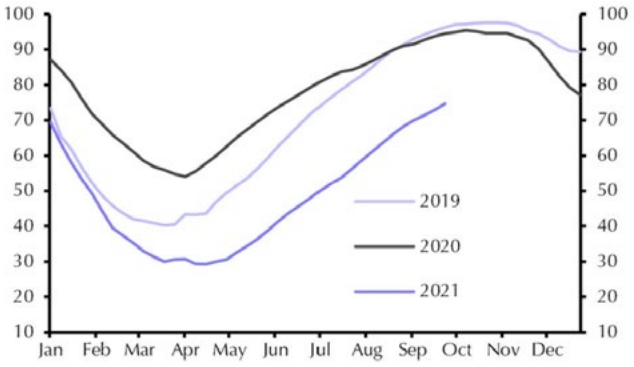
A supply crunch in natural gas has sent prices soaring with Europe already in the throes of an energy crisis.

Gas prices are notoriously volatile and gas contracts are traded regionally. The US, Canada, and Mexico trade among each other and are also exporters. Other top exporters are Qatar, Australia, and Russia. Asia and Europe are importers and in competition with each other for liquefied natural gas (LNG) imports. The main culprit for this year's surge in demand, as well as lack of supply of gas is probably the weather. Unusual weather patterns have meant elevated demand for both heating and cooling when it is usually not needed. Extreme weather events including Hurricane Ida also effected supply at times. There have been disruptions to oil and gas supply in the US and Australia. Droughts in countries including Brazil caused a lack of hydro power. Unusually low wind output and nuclear power plant outages have exacerbated the power shortage.

Meanwhile China's strong economic recovery earlier this year meant a big increase in energy demand; high prices offered by Asia to secure LNG imports resulted in less offer to Europe. At the same time Russia, a key supplier of European gas, has been sending the bare minimum of natural gas to Europe to what is contracted. This is possibly to put some pressure on the politically controversial approval of its new Nord Stream 2 pipeline, a recently completed project that will let Russia transport gas directly to Germany without needing to pay distribution costs to the Ukraine or Poland for transporting it through their pipelines, as is the current situation.

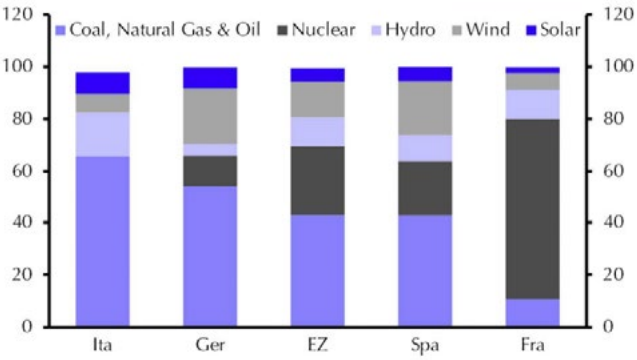
The result has been a surge in Dutch TTF front-month gas prices (a European benchmark) to as high as euro 160 per megawatt hour on 5 October – up from just euro 19.80/MWh at the start of the year. Meanwhile, European gas storage for the winter months is only 71% of capacity, compared to the usual seasonal norm of 92%.

Chart 1) European Natural Gas Storage



Source: AGSI, Capital Economics

Chart 2) Energy mix differs per country



Source: Capital Economics, Refinitiv

Russia does need to balance its desire for approval of Nord Stream 2 with being regarded as a dependable supplier by Europe; at the time of writing Dutch TTF gas has eased back to 108 euros/MWh after an assertion from Vladimir Putin, on urging of the IEA (International Energy Agency), that his country is ready to help stabilize global energy markets.

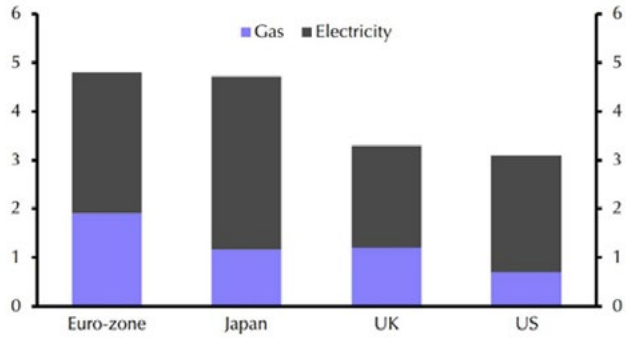
As gas and coal are often interchangeable in power generation, coal prices have also been driven up. Oil prices too have been trending higher, for a different reason: OPEC has not raised output as much as it had promised. Renewable energy sources will, in the long run, be far cheaper and less volatile than coal and gas, but we still lack the technology for sufficient storage capacity for wind and solar energy which is why they are used alternately with gas and coal, depending on how much is generated – this transition phase will last a while yet. Under more normal supply/demand conditions, the medium term sustainable natural gas price is seen to be around 20 to 30 Euro/MWh, but prices are likely to remain volatile and elevated until after the Northern Hemisphere winter, i.e., Q2 2022. How elevated will depend, again, for a large part on the weather – whether this winter will be mild or cold.

How the surge in energy prices will impact European consumers and European inflation, will differ per country. Each country has a slightly different energy mix, with Italy, Germany and the UK being more dependent on natural gas while for instance France having a high share of nuclear power.

Also, the extent to which governments wish to shield consumers from rising energy costs, through price caps or through subsidies, differs per country. Price caps on electricity and gas in the UK mean some smaller energy suppliers have recently filed for bankruptcy; despite the price caps UK consumers are still expected to face a stiff increase in energy bills this winter.

Additionally, energy costs make up a different percentage of the "consumer basket" on which inflation numbers are calculated in different countries.

Chart 3) Weight of energy in CPI baskets for different countries (%)



Source: Capital Economics, Refinitiv

At the time of writing elevated energy prices are expected to add around 0.6% to headline inflation in developed economies, on average, with a good chance that these effects recede next year.

We expect headline inflation in the eurozone and UK to reach 4% this year, before falling back to 2% in 2022. For the US, headline inflation is likely to be slightly above 4% this year, falling back to 3% next year.

The potential of high energy prices to throw the economic recovery off track can work via two channels:

1) higher energy bills can curb consumer demand for other goods and services,

2) if electricity use would get rationed for large industrial users, this could have a negative impact on production and supply.

Regarding the former: the 0.6% increase in energy costs will detract the same percentage from spending on other goods, which will still leave decent growth in real consumer spending.

Regarding the latter: at this point this is not seen as a big risk, except in China, where consumers are fully protected and heavy industry is (already) being forced to bear the brunt of the energy crunch, including the rationing of electricity.

The unusual nature of the current economic recovery after a deep, intentionally induced economic slump caused by COVID lockdowns, makes the interpretation of economic data very complicated, almost like in the aftermath of a war.

Unlike during a war, the production capacity of the economy has not been destroyed, consumers have been supported by governments via furlough schemes (in Europe) or direct cash transfers (in the US), so most economists do not expect "lasting damage" to the global economy. It is however clear that, in moving from an almost complete standstill of much activity to a resumption of "normal" consumption patterns, there are many (temporary) mismatches in supply and demand, bottlenecks, and supply constraints, besides the ones in the energy market described above. In the UK, the combination of the reopening of services combined with the fact that Brexit caused an exodus of non-British workers means acute shortages of skilled labour in transportation, the meat industry, healthcare, and other sectors. In the US, the labour force remains some 3 million people short of pre-pandemic levels; partly because some older workers chose to retire, perhaps partly because not all feel safe yet to return to work given the Delta variant, or due to a lack of childcare facilities; in any case a shortage of skilled labour is quoted as a main concern by many companies.

Chart 4) Record Number of US Companies say Jobs are Hard to Fill

Source: Capital Economics, Refinitiv

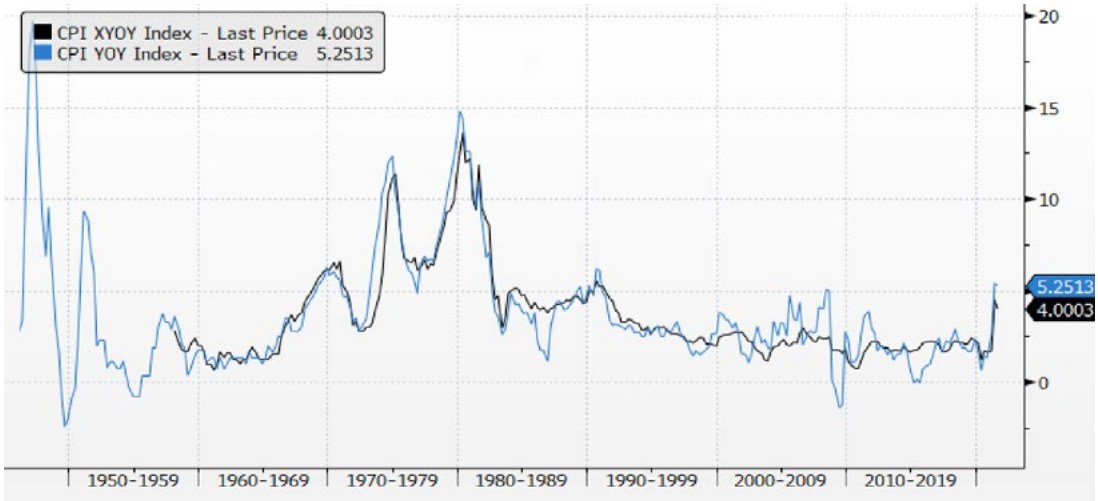
This is putting upward pressure on wages. Walmart, a huge employer in the US (accounting for 1.6 million jobs), recently announced it would increase its minimum wage to $12 an hour, and its minimum wage at its Sam's Club division to $15 an hour, amid a tight labour market.

Meanwhile Amazon, another large US employer (1 million US jobs), is increasing its average starting wage to $18 an hour, and recently instated a minimum wage of $15 an hour. This is good news for many US families and for the US economy as it will support US consumer spending. It will also make inflation perhaps less transient than the US Federal Reserve is expecting. In the EU, workers have remained more "attached" to their jobs via the furlough schemes, and wage inflation due to a mismatch in supply and demand is less prevalent.

How much inflation is too much?

The past two decades have been characterized by unusually low inflation; policy makers have been battling the risk of "deflation", especially since the 2008 financial crisis. The graph below shows US consumer price inflation, for all items (blue line) as well as "core" inflation excluding food and energy costs (black line) for the post World War 2 period.

Chart 5) US inflation – Core CPI vs headline CPI, post WW2



Source: Bloomberg Finance L.P.

The recent jump in inflation is partly due to "base effects", as figures are quoted as year-on-year change and include the lockdown period of 2020 when energy prices plummeted and demand for certain services completely dried up. In European statistics, prices for such services (like airline tickets) were imputed for purposes of index calculation, whereas in US statistics these prices simply fell out of the index so the jump in US inflation looks stronger than in Europe partly because of this difference in calculation methods. Economists estimate that, for G4 economies, 60% of the current inflation increase is due to energy prices, 20% is due to shortages, and 10% is due to "reopening" inflation; together accounting for 90%. Energy inflation is likely to fall next year as the base level changes; it is still an open question how sticky shortages and demand/supply mismatches in goods and labour will turn out to be.

In some areas with supply shortages, like shipping, it takes time to build new vessels and increase supply. Also, the demand for semiconductors still outstrips available production. Labour shortages and resulting wage inflation are likely to remain stronger in the US and UK than in the Eurozone, for reasons explained above.

All in all, we think headline inflation will fall back next year, due to energy prices and base effects, while core inflation will fall more in the Eurozone and Japan than in the US and UK.

In Developing Economies food prices are a larger share of the consumer basket; extreme weather conditions including droughts have pushed up the price of many foods. Despite this, inflation in Developing Economies is on average just over 4% currently, which is not that high by historic standards.

Are we headed for a period of persistently higher inflation? And if yes, how will central banks deal with this?

This has been a topic of some debate and investor angst. Analysing history makes clear that economies and financial assets perform well during periods of relatively stable, positive inflation, up to around 4%. Periods of negative inflation (deflation) or high inflation (5% or higher) are more problematic. The past two decades have been characterized by unusually low inflation, hardly ever exceeding 2% in developed economies. There were several reasons for this, some of which will persist, but some of which are likely to cease or even reverse:

- Demographics – the large "baby boom" generation provided plenty of labour; their growing pot of retirement savings in addition contributed to a growing wall of capital enabling equilibrium interest rates and "risk premiums" to remain relatively low. In other words: there was no shortage of labour, nor of capital. As the last of the baby boomers retire, the labour force will shrink. This will be partly compensated for by new technologies such as robotics, artificial intelligence. Which is why we expect capital spending by companies to remain strong.
- Since China joined the World Trade Organization (WTO) in 2001, an enormous new labour force has been integrated into the global economy via globalisation, putting pressure on wages in developed countries. At the same time labour unions in developed countries have lost much of their collective bargaining power. In previous reports we have written about the current "de-globalisation" trend. To some extent, this is a natural result of global supply chains having reached their maximum level of complexity, and technological developments now making the "reshoring" of certain activities more profitable and/or sustainable. Also, the growing standoff between the US and China is contributing to the emergence of a multi-polar world. This will not completely reverse outsourcing of all goods; there is no reason for the US to suddenly stop importing certain non-politically or strategically sensitive goods such as furniture or toys. But for certain items, especially in the technology supply chain such as semiconductors, there is a growing divide between a US led trade block and a China centred one. For Europe it will become increasingly complicated to determine its position, or perhaps become a third block. In any case, increasing globalisation will cease to be a source of disinflation, for wages as well as for the final price of goods.
- As is evident from the long-term inflation graph above, the 1970's and 1980's were characterized by very high inflation, partly triggered by oil price shocks. Inflation was finally vanquished via a period of very high interest rates, which caused a deep recession but did the job. Two generations later, central bankers no longer have the laser focus on containing inflation that they had in the aftermath of the '70s and '80s. In fact, Central Banks today have been battling the deflationary tendencies described above, which were exacerbated by the aftermath of the financial crisis. In addition, they are starting to broaden their focus to include other issues of a social nature, such as full and inclusive employment (US Federal Reserve), and climate change and the green energy transition, as well as further integration of the Eurozone (European Central Bank). The latter will receive additional support from the fact that the Green party are likely to become an influential part of a new German coalition government, after the recent elections in that country. We are not foreseeing that Central Banks will cease to strive for price stability but do believe they could be willing to tolerate a period of slightly above target inflation to support economic recovery. We currently expect that over the medium-term inflation will remain comfortably below the 5% "danger point", with US inflation trending slightly higher (at around 3%) than the Eurozone or Japan (both expected to trend between 1% and 2% inflation rates).
- Of all major Central Banks, the Bank of England is currently the most "hawkish" and expected to slightly hike its base rate next year, from 0.1% to 0.25%. The US Federal Reserve is likely to begin with tapering its monthly bond purchases at the end of this year; recently announced decent employment numbers support this. The first US rate hikes are still not expected before 2023. The ECB meanwhile will probably continue its bond purchase program, and keep its interest rate at -0.5%, for years to come.

China has been a source of some stock market volatility throughout this year, due to a regulatory crackdown on:

1) Powerful business figureheads (such as Jack Ma, founder of Alibaba Group)

2) Large technology companies enjoying quasi-monopoly advantages (such as TenCent, Alibaba)

3) Companies involved in the for-profit education sector (many of which had become popular targets for public as well as Private Equity investment).

This has caused a near 50% plunge in the Chinese Technology sector index since March, and a broad and often indiscriminate retreat from Chinese stocks in general. Having listened to many experienced analysts/managers who have real life knowledge of Chinese culture, speak the language, and have some understanding of the political climate, the following points are noteworthy:

1) The Chinese government is clearly autocratic, more so under Xi-Jinping than under its predecessor. But it is unlikely to want to stifle, or kill off, its entrepreneurial private sector, as it recognizes that private companies are key to the economic growth needed to sustain the population as well as to the country's coveted leadership role in areas such as technology and innovation.

2) Due to the rapid greying of its population, and the need to achieve adequate levels of broad-based wealth and old-age pensions within a short time frame (as the party's main aim is to remain in power so prevent social unrest) there has been a shift from "capital" to "people". China is no longer primarily interested in building up its production capacity, but in growing and distributing the wealth. Hence the current focus on eliminating inequality, and removing what China calls the "3 Mountains" in the way of equality: property, education, and healthcare.

3) Regarding education: due to its past 1 child policy China faces an acute "baby bust", and in conjunction, has the problem of providing for the greying of the population. It is therefore imperative to its future that families have more children. Despite the relaxation of the 1 child rule, birth-rates have not picked up. The cost of private education (i.e., tutoring to make sure your child gets into university) is a big factor in this.

So indeed, any company that was involved in for-profit tutoring/education has lost its viability (next to the fact that, of course, China wants to keep control of the curriculum.)

4) Regarding monopolies: China, with its autocratic system, has done what many Western governments (the US, the EU) are debating but have not been able to quite achieve: break the power of a handful of large, quasi-monopolistic technology companies that own everyone's private data (the new gold) and thereby protect both new, smaller, innovative technology competitors plus the public whose data are used. This process is painful in the short term for the large incumbents, but possibly a positive for smaller companies, innovation, and the public at large.

5) Rumours around a possible imminent default by one of China's largest, highly indebted, property developers (Evergrande) have worried markets, wondering whether this could come to be China's "Lehman Moment". As far as we understand the situation, the most likely scenario will not be a messy default but an organized restructuring of Evergrande, in which ordinary people (the home buyers who have pre-paid for their property) will be protected, while some large creditors (i.e., financial institutions) will be forced to take a hit. The total exposure of Chinese and foreign banks is far smaller, plus their capital buffers now much higher, than in the period leading up to the Lehman moment at the start of the Financial Crisis.

6) The regulatory whirlwind in China has not quite yet settled, but during the broad-based selling of stocks some babies were clearly thrown out with the bath water. Knowledgeable active managers will be able to pick up companies that are on the "right side" of China's broader economic agenda on the cheap, (such as companies involved in the energy transition, and smaller innovative tech companies that now have a chance of surviving the monopolists). The under-performance, year to date, of Emerging Markets funds is mainly due to the correction in China, which at some point will provide an attractive entry point.

7) Meanwhile China's increasingly provocative show of military might towards Taiwan is a growing geopolitical worry.

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 more reasonable after the recent correction and are justified by low interest rates and continued 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 and possibly the UK 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, as real (after inflation) interest rates remain deeply negative; usually an environment in which small caps can outperform.
- We used the positive market sentiment earlier in September to take some profits in equities for clients whose equity allocation had grown to be more than 5% overweight their chosen "neutral" allocation. The resulting cash will be invested in the Alternatives section of the portfolio.
- Alternative asset classes (private Equity, long/short equity strategies, event driven strategies, global real estate) offer appreciation potential and diversification/hedging benefits.
- 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.

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