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OCTOBER 2021 EDITION

QUARTERLY INVESTEMENT REVIEW

Q3 2021

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NSPGROUP.COM

> *"Interest rates are to the value of assets what gravity is to matter."*
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> Warren Buffett, 1 May 2021

Markets moved sideways during the last quarter, against a poor background of international news. The chaotic exit of Allied troops from Afghanistan, the continued crackdown on some sectors of their economy by the Chinese Communist Party and a brewing energy crisis, all made for a poor backdrop. The stubborn persistence of Covid due to the Delta variant also delayed the reopening of economies. Covid's impact is underlined by the fact that more Americans have died from it than were killed in action in World War II, Korean and Vietnam wars combined. In contrast markets have been bolstered by strong corporate earnings, and government and central bank policy has continued to be extremely supportive.

As we head into the fourth quarter market performance is likely to be determined by the pace of the recovery from the Covid pandemic and progress with vaccine development and its rollout, and by the extent to which inflation remains under control. If inflation does rise then the pressure to raise interest rates will increase and as the Buffett quote at the top of the page indicates that would exert downward pressure on many asset prices. So will the inflation tiger pounce?

Much of the current debate on inflation focuses on the extent to which it is transitory or something more permanent. Clearly some of it is transitory and the result of the supply chain disruption caused by the various lockdowns. These bottleneck issues will resolve. However some inflation looks more structural. For example, the deterioration in relations between the West and China is leading to manufacturing being relocated back to western countries for security of supply reasons, often at the expense of efficiency. Western nations have more health and safety regulations which increase the costs of production. The last few years have also seen an increase in government efforts to address social inequality and make society fairer through measures like increasing the minimum wage, which are inflationary. Moreover both the US and China have announced legislative programs to redistribute wealth. More immediately the labour market is tight. This is partly due to some of the workforce remaining absent because they feel uneasy about returning to work due to age or health concerns, but also reduced migration, and less outsourcing to foreign suppliers. Over the summer there have been multiple stories about staff shortages in North America and Europe. The strength of job growth in the US is remarkable with 10 million jobs on offer against 8 million actively seeking jobs. There is often a mismatch between jobs and the skills required, thus further driving up labour costs. At the same time the disinflationary impact that China has exerted on global wages is lessening. For much of the last 25 years China's labour force has grown by 10-15 million workers a year, which has held global wages down in a competitive globalised world. But now we are reaching a time where China will lose 5-10 million workers a year. This shortage will put upward pressure on wages in China and globally. Rising food and energy prices also add to the pressure. Taken together these factors suggest that wage pressure may not be as transitory as Central Banks hope, as labour finds itself in a stronger bargaining position than for several decades.

The most immediate danger that could spark inflation is the rise in commodity prices, particularly via energy prices. Much of this has been caused by tightening regulation that has discouraged investment in new production and closed production that generates too much pollution, thereby reducing supply. The unintended consequence has been 'greenflation'. Energy prices have been rising all summer to the extent that factories are being closed as leaping energy costs make production unaffordable. As an illustration it was estimated that boiling a kettle in the UK cost 40p compared to the usual 1p, based on having to buy the electricity at the peak rate at the worst time. What is concerning is that this energy crisis has developed before the northern hemisphere winter, and during a period when economies have not been fully open. Airlines, for example, are not running at full capacity. As demand normalises and supply is constrained because the supply response has been crippled by environmental regulation the price pressure will be intense. In Europe this situation has been exacerbated by low gas inventories which have been run down because there has been little energy generated by wind in the last two months. Rises in gas prices are more inflationary than in oil prices because the impact is transmitted more quickly. Oil incurs heavy taxes so when the oil price rises the impact on the consumer is cushioned, whereas when gas prices rise it passes straight through to the consumer. If energy prices continue to surge it would intensify the inflation scare.

This environmentally driven regulation creates risk and opportunities. Clearly if it contributes to generating real inflation then that is bad news for bond markets and those equities that have been re-rated off an artificially low bond yield. Yet paradoxically many of the companies that the environmental regulation is attacking may be beneficiaries because the prices of their product is soaring, and many of these companies are selling at levels much cheaper than the general market. Commodities like copper, cobalt, zinc and lithium are needed to engineer the transition of the world from fossil fuel to renewable power derived from sources like solar and wind. Demand for these commodities will last at least a decade. What is needed is good stewards of the production of these necessary materials. The debate has been too one dimensional, arguing that all renewable energy is good and all sources of energy such as oil and coal are bad. This ignores the fact that the global economy is based on fossil fuels, and a too aggressive transition will cause enormous damage – some evidence of which is seen in the current energy crisis. If the transition is handled badly and the responsible producers of metals are punished too severely, that will hand the advantage to countries like Russia that produce them. If it is handled well it will actually speed up the change to the renewable era. If that is the case then commodity stocks which have been languishing in the market for the past decade will become investable again, as they are moved from the sin bin into the good camp that will develop the green revolution. The potential of many stocks remains considerable as they are bulging with cash, partly because they have been unable to invest in new projects. Whatever the hopes of the more extreme proponents of a green environment, the world will continue to have a heavy dependence on fossil fuels and commodities. Even one of the most advanced countries in developing renewable energy, Norway, has not managed to reduce its oil and gas consumption. Virtually all other countries' growth depends on increasing it.

Tightening regulation in some sectors of the economy in China has rattled markets. The most obvious sector is private education, and these companies have seen their share prices decimated, as the Communist Party attacked a sector that they felt was creating too unequal a society. The companies badly affected have been those that the Party perceives as being in conflict with the Party. Big technology companies have come under the microscope everywhere because of their size, anti-competitive issues and unaccountable control of data, but in China the system of governance allows them to act faster. China's size, growth and strategic importance makes it fundamentally attractive to investors but the increasing involvement of the government in the economy makes for uncertainty. First it has led to a realisation that shareholder rights are always subsidiary to the Communist Party's objectives, and if these conflict then the company has no recourse to fight back. Second is the question about how compatible a system of centralised control can be with the need to develop a diverse and vibrant services economy. The State's overbearing presence isn't usually conducive to the creativity that these industries thrive on. The opportunities in China will need to be aligned with the Party's desire to create more common prosperity.

In contrast Japan's market has been encouraging. This year has seen a steady rise of increased dividends, share buybacks and rationalisation of minority interests. The market remains cheap relative to other large international markets, and the opportunity for further restructuring is substantial. This opportunity is being exploited by private equity funds which should lead to a multi-year story, given the opportunity that still exists to reduce both fixed and variable costs which will further enhance cashflows. Something is going right in Japan because the Government has just announced record tax revenues for the year to March 2021, despite the problems caused by Covid. This record is testament to the significant profit improvements in Japanese companies.

The Afghanistan debacle, China crackdown and energy alarms have made it an unsettled summer. But company earnings have been strong and slowly the pandemic is being addressed. Idiosyncratically there are plenty of opportunities in equities of which the commodity story and Japan are highlights. Significant concerns remain of which the greatest is the indebtedness of the global economy, which makes it vulnerable to more appropriately priced interest rates. Some areas of the equity markets are vulnerable, particularly in the US, where the S&P 500 is 30% above its pre-pandemic peak in February 2020 as the liquidity stimulus provided by the Federal Reserve has pushed up asset prices. Most investors remain packed into bonds, growth stocks and big technology companies which have been least affected by Covid and therefore a good hiding place. After six months of moving sideways despite a supportive strong economy the cyclical part of the market looks mispriced, and this looks to be where the best opportunities now lie.