Quarterly report, Q2 2021
Value Equity

Sparinvest

THE INFLATION EDITION

We have often written of the relevance to value investing of interest rates, and that key underlying driver of them, inflation. Developments in recent months have confirmed that relevance, as whispers of inflation grew into signs that are more concrete. In this letter, therefore, we expand on the question of inflation.

U.S. inflation, measured excluding food and energy, was 3.8% in the year ended May 2021, the highest 12 month rate for that specific index in the U.S. since June 1992. Including the more volatile food and energy components, prices in the U.S. rose by 5% in the 12 months ending May 2021.

Some degree of inflation was anticipated as lockdowns ended, however disruptions to global supply chains combined with rising consumer demand have caused shortages with consequent price rises. The rises in prices are not confined to the U.S. Countries in Asia and Europe are also reporting significantly higher inflation rates. However, the world has a unique sensitivity to U.S. interest rates, which makes the actions of the U.S. Federal Reserve (the Fed) and the path of U.S. rates a subject of global importance. The dollar's role as the preferred currency of global trade make U.S. rates important. Currency pegs to the dollar are less prominent than in prior decades, but - particularly in emerging markets - there is still a large degree of dollar rate sensitivity in domestic currencies. If U.S. inflation rises, the potential remains, as in prior decades, for it to be exported around the world.

Despite the fact that some level of inflation had been so well anticipated, the headlines related to rising prices, and central bank responses, were a large determinant of market direction over the second quarter. Reflecting the importance of this return of inflation to the economic landscape, and the resulting monetary policy responses, we focus this letter on understanding different elements of inflation.

Firstly, we examine in more detail exactly why inflation has reappeared. The simplistic analysis from above that attributes inflation to reopening, bears some examination for the purpose of validation. The reason we wish to validate that assumption is that we wish to understand how long inflation will be with us. Is it a largely benign transient visitor as suggested by the central bankers, or is there something structural afoot?

Secondly, we examine the interplay between inflation and rates to understand why we care about inflation. Interest rates are a tool of central bankers to manage inflation; however, they also play an important role in pricing risk in financial markets. The long period of low rates has led to misallocations of risk that will inevitably unwind if rates respond. However, we need equally to recognize that inflation is a symptom and not a cause of underlying economic conditions and those underlying economic conditions are the ultimate determinant of corporate profits and markets.

Finally, we analyse the impact on companies and the impact on investing, with a particular focus on the consequences for the value style. Many executive teams, admittedly in common with many investors, might barely remember inflation. U.S. inflation has been in the low single digits since the mid-1980s. In Europe, the primary concern over the past decade has been one of deflation. Japan has been battling deflation, with limited success, since the beginning of the 1990's. Managing a business in a time of rising prices requires a different skill set, and different industries and companies will navigate it with differing degrees of success.

Second Quarter Market Developments

The continued repeal of lockdowns was interrupted in some markets by the explosive growth in the newly titled Delta variant of COVID-19. The new variant, by some measurements up to four times more transmissible than the original COVID-19 coronavirus, led to rising infection rates in countries such as the UK. Fear of the Delta variant led to continued travel restrictions and put at risk the summer recovery much hoped for by travel and tourism industries. The one positive piece of news from the outbreak in the UK was the variant's apparent lack of vaccine resistance, leading to a breaking of the connection between infection and hospitalization rates. However, as the quarter ended an outbreak of the variant in Australia caused concern. Australia had largely cut itself off from the world and successfully restricted its COVID-19 cases; however, it has failed to enact a meaningful vaccination program leading it to be critically exposed to the Delta variant, potentially.

Early June saw a G7 summit held in southwest England against a backdrop of yet unresolved BREXIT trade issues between the UK and the EU. As is typical with G7 summits, many pronouncements were made, this time involving commitments on vaccine sharing and climate change, which arguably did not go as far as many had hoped. However, one of the more interesting agenda items pushed by U.S. President Biden was the concept of a minimum global tax rate. The use of tax optimization strategies by multinational corporations has led to some extreme disconnections between tax paid and economic activity, raising concerns over equality and fairness. However, considering that a number of the world's most significant economies, such as China and India, along with essentially the entire world's low tax regime markets, are not represented by the G7, the exact impact of the higher taxes is likely to be lower than initially reported.

Markets in the second quarter were generally strong, despite the emergence of the Delta variant, with the MSCI World index rising by 6.78%. European markets outperformed the U.S. for almost the entire quarter, but softened in the last couple of weeks of June as U.S. markets continued to rally. This meant U.S. markets ended the quarter slightly ahead of European markets. The driver of strong U.S. returns late in the quarter was clarifying commentary from Fed chair, Jay Powell, over the speed of U.S. interest rate rises.

Japan was a particularly weak market in the quarter, declining slightly, as the country worked to get to grips with its COVID-19 infections even as the government affirmed its commitment to hold the Olympics, due to start in late July.

Emerging markets were on average slightly weaker than developed markets, although the MSCI Emerging Markets index still posted a 4.11% return. India began its slow recovery from the most recent wave of COVID-19 that wreaked devastation on its populace, and Indian equities responded to that recovery with strong performance in the latter part of the quarter. China however, battling its own inflation concerns, underperformed the MSCI Emerging Markets Index.

Inflation, are you sure?

The global financial crisis of 2008–2009 provoked a fiscal and monetary response of hitherto unimaginable size, including tools such as quantitative easing – the buying of bonds to expand the money supply. Although the scale of the response was almost modest compared to the recent global response to the COVID-19 pandemic, at the time it raised fears of significant inflation, even doom-laden forecasts of hyperinflation. However, despite a couple of monthly bobbles in the headline figures, the net impact from all this policy action was that inflation remained low.

The Euro crisis that began as the global financial crisis ended, rumbled on for several years until in July 2012 European Central Bank president Mario Draghi committed to do 'whatever it takes' to save the Euro. The 'whatever' included significant purchases of sovereign debt, as Draghi faced down the cries from inflation hawks, notably at the Bundesbank. History proved Draghi was in the right. Inflation has remained low across the Eurozone in the past 10 years.

Among the four words, an investor should fear the most are "this time is different". The long perspective suggests that it never is that different. However, something has changed: inflation now is an observable phenomenon.
Some sources of price rises are a clear dislocation related to reopening, and these can reasonably be expected to correct given time. In the U.S., there are used cars selling for a higher price than when they were new - absurd until you consider the lead-time for delivery of a new car starts at six months and depending on the model could extend to over a year. However, when supplies of new cars recover, which in itself is contingent on a recovery in the semiconductor supply chain as discussed in our letter from the first quarter, the prices of used cars will surely adjust down.

Other sources of price rises are part of the natural cycle of commodities. In March, hog futures in China spiked to record highs as consumer demand has been rising at the same time as supply was significantly curtailed by an outbreak of African swine fever. High prices led to significant increases in Chinese inflation; however, they also prompted significant slaughter by domestic farmers, leading to steep price drops, a natural price response.

There are also price rises that we are all aware of but do not contribute to the basket of goods that comprise inflation. Inflation indicators incorporate housing indirectly through implied measures of rent expense. This approach fails to capture the rise in house prices experienced in many Western European and North American markets. U.S. house prices have risen by almost 15% in the year to April 2021, the highest pace of national growth in 30 years. In the UK, house prices rose by 13% in the year to June 2021, the fastest pace in 17 years. Much of the rise in demand has been attributed to a lockdown-motivated desire for more space to accommodate remote working lifestyles, fueled by low interest rates and in some markets boosted by temporary tax holidays on house purchases. These explanations may well account for the fast rising house prices, however, they also point to another conclusion – that low rates have encouraged risk taking and financial leverage amongst households, a not so faint echo of the years leading to the financial crisis.

However, the sources of price rises that give central bankers the most immediate cause for concern are those smaller everyday price rises that on their own seem to account for nothing, but cumulatively have the ability to change long term expectations. Maybe on your first post-lockdown visit to a restaurant you noticed that the portions of food and drink were smaller. Possibly, after months of homeworking you finally needed to refuel the car and the price of petrol led you to raise your eyebrows. Perhaps you have seen the adverts for staff in service industries and noticed the starting wages seem to be notably higher. These are all sources of inflation and they are all contributing, either directly or indirectly, to the headline figures of recent months.

So why are central bankers not worried? In short, they generally believe that these various price rises are temporary in nature and that as economies reopen prices will normalize. Commodities, as recently demonstrated by hogs in China, have a natural cyclicality. Despite rising wages, unemployment in most countries remains well above pre-pandemic levels, suggesting that the workforce is there but not currently utilized. The risk is that inflation expectations rise, leading to the cycle of rising wage expectations that drive inflation higher, however in the view of central bankers across developed markets, that risk is low.

Inflation, who cares?

As described above, central bankers are sanguine over the outlook for inflation, and have many reasons to be so. Markets, however, do not completely share the central banker's sanguinity.

At the end of March, Jay Powell (the Fed chair) suggested that it saw no reason to raise U.S. rates before 2024, as the inflation risks were seen as transitory. These comments provoked a significant sell off in long dated U.S. Treasury bonds – pushing long-term yields up - as markets factored in the likelihood of greater inflation at some point in the future. Moderated comments from Powell over the subsequent few weeks provided some stability to the market even, as the Fed considered reducing its asset purchase program. The Fed is currently purchasing $120B of assets, including approximately $40B of mortgage-backed securities (MBS). The intention of these purchases is to flatten the yield curve and stimulate the areas of the economy dependent on longer dated borrowing. However, considering the recent trajectory of U.S. house prices, the MBS purchases in particular are beginning to look redundant. The Fed has given plenty of notice to bond markets of the declines in asset purchases in an attempt to avoid the 2013 'taper tantrum' when, faced with the reduction of asset purchases, bond market yields spiked. The measured reduction in asset purchases is the first tightening mechanism available to the Fed; however, markets are already looking beyond the reduction in asset purchases towards actual rate rises. By mid-June the Fed had already bought forward its expectations of a rate rise from 2024 to 2023, however, markets are still ahead of the Fed, with markets pricing in one full rate rise before the end of 2022.

Since the early 1980s, monetary theory has been the economic orthodoxy on inflation. Central bankers have used interest rates to manage inflation within their economy. Targets have evolved from price stability, to inflation targeting, to average inflation targeting where an across cycle average level of inflation is aimed for. However, interest rates have an important role to play beyond managing inflation. They, or more properly, real interest rates, are the mechanism for pricing risk. Real interest rates are merely the difference between the nominal, headline, rate and inflation. Real interest rates influence everything from company's capital spending decisions and consumer purchasing decisions to asset pricing. Often nominal and real interest rates are referred to somewhat interchangeably, which is fine when inflation is relatively constant. However, at times of rapidly rising inflation (or for that matter rapidly declining inflation), the difference between real and nominal rates becomes significant.

Changes in the nominal rate must also be considered in reference to the real rate. If nominal rate hikes lag the rise in inflation, then real rates will be declining and the economy becomes even more overheated, requiring more rate rises in the future. This fear is the driver of the bond market in the recent quarter. Long maturity yields that had been rising since last summer began to rise dramatically as the Fed suggested it would be slow to raise rates. Long maturity yields declined when the Fed bought forward the date upon which it expected to raise rates. This seemingly counterintuitive move in bond yields merely reflected the bond market belief that the sooner the Fed raises rates, the fewer overall rate rises will be needed.

So to answer the rhetorical question titling this section, do we care about inflation? We care about inflation because uncontrolled inflation brings costs to society through inherent uncertainty of pricing as well as devaluing savers on fixed incomes. However, inflation is merely a symptom of underlying economic conditions and as investors; we care about the real interest rate as this determines the return on future investments and allow us to allocate investments based on risk. With very low real interest rates, risk can be misallocated and assets mispriced. It is hard to argue that low real mortgage rates were not at least one of the reasons for higher house prices. Sharp house price rises are increasing risk within the housing market in many countries, with memories still fresh of the last time this happened in that particular asset class.

Inflation, what do we do?

We could now take our cue from the esteemed central bankers of the world. They are not worried about inflation, so why should we be? The reality is that much of the recent inflation spike has been a result of a dislocation due to the reopening. If inflation is a symptom of the utilization of the underlying economy, then other indicators, most notably employment, support the view of central bankers. Inflation will very likely decline over coming months as supply chains are repaired, labor markets normalized and commodities respond to high prices with more supply.

However, irrespective of the short-term path of inflation, there are some reasons to expect inflation in the medium term to be higher than in the past decade. We have focused this letter on the monetary response to inflation, however, there are also fiscal and operational changes occurring that are driving the global economy. Massive government fiscal stimulus, in both the U.S. as well as the EU will drive economic activity. China, long an exporter of deflation through its exports of low priced goods, is feeling internal pricing pressure as a commodity importer. As China re-orientates to an internal marketplace, that could reduce pressure on exporters to maintain market share outside China by absorbing higher costs, leaving them more willing to export at higher prices. Finally, the decoupling of global supply chains, in response to fears over the safety of supply chains, will lead to higher prices that will end up being passed on to end consumers.

We have focused this letter on U.S. inflation in particular, which is justified due to the unique role U.S. rates have in global markets. The dollar is the default currency for trade, most traded commodities are priced in dollars and many companies and countries borrow at least partially in dollars, taking advantage of the lower risks perceived for dollar loans. Higher rates impact all of these markets. Markets are not yet anticipating any rate rises from the European Central Bank in the next couple of years, and short-term yields are expected to remain negative for years to come despite inflation spikes during the second quarter across the Eurozone. Many emerging markets, with the important exceptions of China and India, are commodity exporters. Rises in commodity prices benefit their economies although they can also lead to inflation within their economies. China and India, as energy importers, also remain exposed to higher oil prices.

For companies, grown used to a stable price environment, higher inflation and higher expectations of inflation bring new challenges. The most immediate challenge will be considering how and when to transmit rising input costs to customers. The competitive situation a company is in will influence that decision, as will the ultimate price elasticity and substitutability of its products. These are classic commercial decisions, but utilize skills that have not been needed for some time. Prior to the pandemic corporate profit margins in developed markets were the highest in over 20 years. Although average margins in emerging markets had yet to rise to the levels achieved in the commodity super-cycle of the early 2000s, they were at a decent and stable level. Rising input costs have the potential to pressure profit margins.

The bigger challenge for companies, however, is the impact from rising wages. As discussed above, despite the still high unemployment figures in both the U.S. and Europe, companies are struggling to fill vacancies and are having to offer higher wages to entice applicants. If rising consumer prices feed into expectations for rising wages then this spiraling of inflation expectations becomes a difficult environment for companies to manage in the short term. Longer-term productivity investments can mitigate the rise of wage costs in some, but not all, industries.

As equity investors, we also need to respond to inflation in two ways. The first thing to understand is the impact of inflation on the companies in which we invest. Some sectors have been beneficiaries of the recent decades of low inflation. Typical beneficiaries have been companies with either low levels of fixed costs or highly variable labor forces. Technology companies in particular have benefitted from outsourced supply chains to low cost countries. Equally, some labour intensive service industries have reinvented their labour models. For example, delivery and taxi services, benefitting from benign labor markets, have traded perceived employment flexibility for low wages, with the companies not the employees being the ultimate beneficiaries. However, businesses with significant fixed cost footprints, such as factories and equipment, have suffered as low inflation or even deflation has made leveraging their fixed costs ever harder, i.e. it becomes harder to increase revenue to offset the fixed costs and improve profitability. Traditional manufacturing industries with fixed assets have generally struggled with lower inflation levels, with one natural response being lower levels of fixed cost renewal – with profitability lower, it is harder to justify replacements for such factories and equipment. As discussed above, competitive landscapes and availability of labor will determine the success of individual companies within each sector to respond to a period of higher inflation.

The second way we as equity investors need to respond to inflation relates to the normalization of interest rates. Rates play a critical role in the allocation of risk in financial markets. The higher the risk of a series of cash flows, the higher the discount rate that should be reasonably attached to those cash flows. Cash flows occurring far in the future should naturally be discounted the most, due to the principle of the time value of money. Equally when investing for longer periods, a term premium is required to compensate for the lack of certainty around future economic conditions. This is why the yield curve of borrowing rates is typically upward sloping. When central bankers force interest rates to low levels and yield curves to flatten, the mechanism for transmitting risk within markets is at risk of becoming distorted. In extreme cases, there will be an excess demand for high-risk assets that are dependent on cash flows far into the future, potentially leading to the formation of bubbles. The difficult part of analyzing bubbles is that they are only obvious with the benefit of hindsight. Before the bursting of a bubble, be it mortgage backed securities in 2007, equities in 1929 or tulips in 1600s Holland, there is always a way to justify valuations. Justifications will come couched in concepts of technological change driving a new permanent growth level (1929) or pessimists overstating risk in the housing market (2007), however, the root cause is always a mispricing of risk.

It is unwise to suggest we have absolute clarity on whether certain segments of the equity markets have reached bubble territory. Certainly, the discrepancy of valuations between growth stocks and value stocks is at an extreme level, unsurpassed in recent history. The recent modest value rotation has done little to dent the discrepancy. The mathematical certainty is that entering low discount rates into discounted-cash flow valuations leads to high-implied valuations for growth stocks, as their higher projected cash flows in later years are discounted less. The question is whether this adequately reflects risk. Such valuations favour many growth stocks at which, in reality, consistent positive free cash flow generation – the ultimate driver of valuation – in fact remains a distant promise. Of course, there are also many companies with solid cash flows now, along with projections for these to continue compounding far into the future. Again, low discount rates imply high valuations for such companies, which may act as 'bond proxies' – but again, the question is whether this adequately prices the risk. A downturn in the economic cycle or a change in competitive conditions could demonstrate that the cash flows have more risk than currently perceived.

As value investors, we are well used to being told that we do not understand, that "this time is different". However, we retain our preference for stocks with either current positive free cash generation, or at the very least a clear path to near term generation of those cash flows. Equally, we avoid companies where the market is not adequately incorporating the risks associated with those cash flows. Certainly many of the industries we find value in are the industries poised to benefit from the forthcoming fiscal stimulus – industries in traditional manufacturing and industrial segments, typically with some degree of fixed cost infrastructure that will benefit from a little inflation leverage on their cost base. However, we also find plenty of value in less cyclical sectors, focusing on companies whose cash flows have been overlooked by the market. Of course, in any of these, we take comfort in buying companies whose valuations do not appear stretched.

Inflation will most likely retreat in the short term, however, in the medium term we see fiscal stimulus as driving a tightening in economic utilization rates, benefitting more traditional industrial and manufacturing companies with fixed investments. Equally, we see risk in certain segments of the equity market where valuations have been disconnected from economic prospects because of distortions in the interest rate.

Our holdings

Overall markets were whipsawed during the quarter by inflation figures and the Fed declarations, and the impact of these reports was no less pronounced on the rotation between value and growth. Growth equities had the best of the quarter, with only May showing significant value style outperformance as the initial inflation figures were reported. June was a particularly difficult month for the value style as central banks stiffened their spines and offered stronger inflation fighting language.

Despite the headwinds in the quarter from the value style, a number of our holdings had strong performance, particularly holdings in traditional industrial sectors. Swiss company Rieter is a modern manufacturing company in an old industry. The company's main products are machines serving the cotton and textiles industries. Despite the fact that this industry has been around a long time, Rieter sells advanced machines to textile customers who are looking to drive efficiency and is well placed to benefit from industry growth in markets such as Asia. Rieter is benefitting from very high post-pandemic utilization in the textile industry and the stock was a very strong performer in the quarter.

SoHo China is a property developer based in China. In June, the company received a buyout offer from Blackstone, the global private equity and alternative investment group. The offer price, a significant premium to the previous trading price of the stock, led to significant performance from the stock in the quarter.

Scholastic Corp is a U.S. based publisher of books, focused on children and educational segments. The stock had very performed well in the quarter, partly driven by the return to the classroom of schoolchildren with the expected rise in demand for books. However, an additional factor in the performance of this stock was the unfortunate passing in June of the CEO, Richard Robinson Jr. The market reaction to the passing of Mr. Robinson was not a verdict on his CEO skills, but more a reflection that – because he was the sole owner of the Class A stock of Scholastic, giving him control of the company - there may now be an opportunity for an ownership change for the company. The publishing industry consolidation has largely passed Scholastic by; however, market participants clearly recognize there is potential for catch-up here.

As evidenced by the actual buyout for SoHo China as well as market anticipation of the potential for scholastic, M&A is a theme we are seeing more of this year than for several years and this may well be a topic we return to in a future letter. Irrespective of how value is realized, whether through M&A or the long slog of improving earnings and generating cash flows, we focus our portfolio on stocks that have the potential to significantly perform. We use our discipline to not only invest in areas of the market that have been overlooked, but also to avoid market segments and individual stocks that we fear have become overpriced due to the underpricing of risk.

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