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# QUARTERLY INVESTEMENT REVIEW

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In 2021 while the world wrestled with the Covid virus, and its evolving variants, the financial markets enjoyed another strong performance thanks to the enormous stimulus that Central Banks continued to provide. Authorities' response to Covid in the last two years has produced the most stimulative monetary and fiscal policies since 1945. In the US, for example the total agreed and intended fiscal stimulus amounts to 35% of GDP, a sum comparable to the cost of the Second World War. Real interest rates are minus 4%, again the lowest since 1945; the economy has never gone into recession when real rates are negative. However, the debate has now turned to whether this gigantic stimulus is starting to stoke structural inflation. Inflation has reached 6.8% in the US, a 40-year high, and has been climbing all year, so Central Banks message that it is only transitory, is coming under scrutiny. The outcome is critical for 2022, because with markets awash with cash, if the stimulus is withdrawn quickly they look vulnerable as they show signs of significant excess. For example, in November the car company Tesla reached a valuation of $1.2 trillion. This was more than the next nine largest car companies combined, and left its founder, Elon Musk, worth more than Exxon. It was also double the value of Warren Buffett's Berkshire Hathaway which had profits in the first nine months of the year of $50 billion, compared to Tesla with only $36 billion in sales. A tightening of liquidity could dramatically impact companies such as Tesla which have benefited so much from the easy conditions of the last few years. Whether these conditions do change depends largely on the course of the virus and inflation.

As vaccines are rolled out globally, hope is rising that economic lockdowns will end. The scientific achievement in producing the vaccines is extraordinary, and highly profitable for some – the Pfizer-BioNTech vaccine is now the best-selling pharmaceutical product in history. Setbacks were occurred with the appearance of the Delta variant, and now Omicron. However, as vaccines armour plate the population, allowing us to live with Covid, the pandemic stage of the crisis will pass. This point is being reached faster in the West than in Emerging Markets but in these too progress is accelerating. New variants are always possible and further reversals cannot be ruled out, but on current information there appears to be a decent chance that Covid comes under control during the course of 2022. What 2021 made clear is that when permitted the recovery has been strong. If the vaccines succeed in a full reopening, then it will release considerable pent up demand, which will further inflame the inflation debate.

Central Banks contention that inflation will be transitory is almost certainly correct with regard to most manufactured goods. Once the bottle necks and supply chain disruptions caused by Covid are sorted out these prices will settle down. However, other factors may not be so simple. Covid has highlighted the fragility of the just-in-time supply chains which have come to dominate global trade, particularly where production of a key component is the other side of the world. Rising nationalist tendencies and security of supply issues are prompting countries to bring production closer to home. This is inherently inflationary, as the whole reason to place production overseas was lower price. Another issue is Congress passing on 5th November a $1.2 trillion infrastructure bill. America is in obvious need of this as government investment in non-defence structures had fallen to 1.6% of GDP, the lowest since 1948, and the average age of government fixed assets had risen to 28.8 years, an all time peak. An even bigger investment bonanza will be in the decarbonisation theme, the cost of which has been estimated at $60-80 trillion. Both the Democrats in the US and the Greens in Germany are actively pursuing this agenda. Taken together this largesse will fuel inflation. Another politically driven source of inflation is the desire of governments to redistribute income to the benefit of lower income households. The storming of the Capitol in January was a wake-up moment for politicians because it indicated how bad things had become, and the need to provide more assistance to these lower income workers. These groups tend to spend their money, not hoard it, and this spending drives growth and pushes inflation in basic goods. Food costs for instance are rising fast. In October the Financial Times published a breakfast indicator (consisting of coffee, milk, sugar, wheat, oats, orange juice) that was 63% above the end 2019 level, and 26% up since the end of June. In the year from November to November the cost of agricultural inputs rocketed up – phosphates by 87%, potash by 129% and nitrogen by 114%. In October John Deere granted an immediate 10% wage rise to its 10,000 unionised workers, and agreed to adjust wages each quarter based on inflation. Another sign of increased bargaining power is the number of strikes in America last year has risen from 7 in January to 58 in October. Increased pay settlements are becoming widespread. This labour inflation may be hard to contain, especially with unemployment levels so low. Political and economic forces are forcing wages up, and this will only increase as economies reopen. Labour inflation tends to stick, it is very rare that wages are reduced. The booming employment market only adds to the pressure.

One of the big beneficiaries of the increased infrastructure spend and decarbonisation theme is the commodity sector. Higher commodity prices are inflationary, and this has been greatly exacerbated by environmental lobbying. For excellent environmental reasons there is a strong push to reduce the use of fossil fuels and replace them with energy supplied from renewable sources such as solar and wind. The problem is the inability to store the energy from these renewable sources that leaves the world dependent on fossil fuels, which still supply 85% of the world's energy. Oil and gas production have been woefully underinvested, while renewable energy is not able to fill the gap. The oil and gas companies have been very reluctant to invest in new capacity, given the hostility to the industry, and also to appease shareholders who prefer the large cash flows to be returned to them as dividends. Global exploration budgets have fallen from $100 billion ten years ago to $50 billion today. Environmental pressure has severely restricted the supply response that would normally solve the shortage. One result was the dramatic spike in gas prices, causing grids to collapse in regions as diverse as Iran, California, UK, Japan and China. It has resulted in an energy crisis that most investors cannot invest in, for fear of being attacked by the green lobby. The problem extends beyond fossil fuels to other capital-intensive sectors like mining, cement and shipping. It will take years to rebalance this, and the task is made harder by the difficulty of raising capital due to environmental factors and a dearth of investors willing to participate. Increasingly the power in these markets is flowing to those places that care less about clean production such as Russia and Saudi Arabia. It is one of many ironies that the campaign to clean up the industry has resulted in it falling into hands which are less regulated. A further concern is that history has shown that when the oil price spikes as it now threatens, it is common for an Emerging Market to crash from the economic stress imposed by high energy prices.

If demand strengthens it will force the price of oil and gas higher, but many materials critical to the evolution of renewable energy are likely to continue rising. Energy generation from renewables is commodity intensive. The vast sums raised to improve renewable energy production depend on supplies of copper, lithium, nickel, manganese and graphite and other critical materials. It is hard to see how their prices won't rise given the demand. Regulation further underpins higher prices. One of the decisions to come out of the COP 26 was an agreement to reduce methane by 30% by 2030. In Texas alone upgrading wells to comply will cost $4 billion, but more seriously it will occupy an estimated 256,000 manhours. Earlier this year Grupo Mexico, one of the largest producers of copper, announced that it would add no new capacity till 2028 while it corrects its existing operations to environmental standards. Distracting these resources away from producing new supply reinforces upward price pressures. These pressures are likely to continue until voters force governments to take action if price rises cause too much hardship.

Chinese markets had a poor year in 2021 as investors fretted over the slowdown in its property market, and potential conflict with Taiwan. Taiwan's boisterous democracy upsets China's increasingly Leninist leadership, but so long as Taiwan does not declare independence, a military confrontation appears too great a risk for China. The property situation is more concerning. Property has been the sector through which the Communist Party has stimulated the economy and helped it attain the ambitious growth targets of their five-year plans. China's attempt to pivot from an investment/export driven model to a domestic consumption one is a difficult transition. Deleveraging property and banking bubbles is an adjustment that few countries have achieved smoothly. However, China's control of its financial system gives it an advantage other countries' have not enjoyed. China's vast economy should still provide plenty of investment opportunity, but investors will probably want to see more clarity from China's leadership that private capital is still welcome before the market can recover.

The threat of inflation being more persistent than envisaged by Central Banks, and monetary policy needing to be tightened, renders bonds unattractive. It is a sobering fact that since 2014 an investor in the German 10-year bond has had no return. Most equities are not expensive when measured against ground-hugging bond yields, but if rates start rising then everything will need to be reappraised. Equities that act like bond proxies would be de-rated, but perhaps the most vulnerable area will be the highly rated concept companies. Zero interest rates allow investors to be patient with companies with good long-term prospects because their funding is so cheap, but as interest rates rise investors demand immediate profitability and those companies on 50 to 100 times earnings face a much harsher environment. The really speculative end of the market consisting of companies with little earnings, or even revenues, will be hit hardest. Meanwhile the opportunities may be in the more cyclical parts of the market which look mispriced. Index performance has been driven by defensive and growth stocks which performed well in the last decade which was dominated by austerity policies. If growth does return then the opportunity should broaden. Wage growth in lower income households will boost retailers and their supply chains. These companies have endured a tough decade which has reduced competition, so the combination of strong employment and wage growth put them well placed to benefit from the recovery. The re-shoring of production will require rebuilding all the infrastructure that surround businesses, offering multiple investment opportunities. The various infrastructure developments and decarbonisation trends likewise creates new demand. The tourism, entertainment and aviation industries would also be obvious beneficiaries from economies reopening. As Emerging Markets recover, their markets should also perform better. A barbell strategy of these ideas mixed with the dominant US megacap technology companies seems best until the inflation narrative is clearer. The US tech giants still deserve a place in the portfolio due to their prodigious profitability.

Entering 2022 Central Banks face a conundrum. If they provide too much stimulus then inflation may run higher, but they will be loath to lose the recovery they have generated since Covid struck. So much depends on how quickly the world gets on top of the virus. When bad news is announced markets tend to shoot first and ask questions later, making life volatile for investors. However, if strong evidence emerges that vaccines are conquering the virus and we are developing immunity, then growth should be very strong. Then particular attention needs to be taken that surging energy prices don't 'break things', bonds should be avoided, and equity portfolios deployed more to cyclical and recovery areas. For currencies the US dollar's recent strength may fade, and it may weaken against the euro and yen, and also those Emerging Markets currencies strongly backed by commodity resources.