Psigma
Investment Management

View from Psigma

Valuation Commentary

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"The Heat is On"

Obviously overwhelmed by the football event consuming the UK a few months ago, we wrote in our last quarter-end update in July that the period January to June 2021 was a "game of two halves". The first three months of the year saw expectations for economic growth and inflation rise, whilst the second quarter was a period of concern over the emergence of the impact of the "delta variant" on the economic recovery and a cooling of inflationary forecasts. The third quarter has been a frenetic period where both of those overriding views have clashed together, with concerns over inflation now starting to dominate the minds of investors once again as we enter the final few months of the year. The experience of the "rollercoaster ride" that 2021 has been so far teaches us that it is the expected outcome for inflation – in our eyes an investor's greatest risk – that will dictate the pattern of returns across various asset markets. It is also the subject that we are currently sensing the most concern and receiving the most questions about from our clients, so that is where we shall focus most of our attention today.

The major change in the outlook?

As we wrote in our latest View named "The Wind of Change" in early September, we believe that the structural outlook for inflation has changed from the last decade. We should stress at the outset of this discussion that we do not envisage a Weimar Republic inflationary spiral, but rather that there will be greater inflation uncertainty in the "Turbulent Twenties" ahead, and that the prospect for higher average prices is real. This is a major change for us all to consider, and we are surprised by how relaxed most financial markets appear to be about the shifting sands of the inflationary picture. In the post-financial crisis years, it was the consistently low rates of inflation that afforded central bankers the opportunity to keep interest rates at rock bottom levels, which in turn helped to keep economies humming away gently and asset prices elevated at historically high valuations. We can now identify several cyclical inflationary forces amassing throughout the global economy, which, contrary to the protestations of central bankers and politicians, could prove to be far "stickier" than the "transitory" message peddled by the monetary authorities and most financial commentators.

Could inflation be "transitory"?

Certainly, we have some sympathy with the view that COVID-impacted supply chains will become smoother through time and demand for certain goods and services will also normalise, after the distorting trends of the pandemic hopefully wane. There is also no clear evidence that we are going to see sufficiently strong broad-based demand in the coming years to create supply shocks, although there is the chance that government stimulus and pent-up demand arising from the pandemic continue to keep various sectors and products en vogue. We also agree that the huge debt piles amassed before, during and after the COVID crisis will act as an impediment to productive growth and could weigh on inflation. Finally, the argument over technological disruption ensuring cheaper access to many goods and services should remain relevant as this decade progresses, even if we believe that most of the "easy yards" have been achieved and have already helped to reduce costs for end consumers.

And now for something completely different

But that's where the similarities to the last decade's inflation experience probably end. Our view has always been that inflation is partly political and mostly psychological, and, in our opinion, it is these major aspects that have changed. The developed world's governments have clearly taken the view that inflation is both "politically acceptable" and "politically palatable". In theory, inflation should help to whittle the teetering debt piles that governments have allowed to soar, through years of questionable decision making and relaxed attitudes to spending money that they didn't have. As we consider the myriad changes across the world in the last 18 months, one of the more blatant is that there is now considerable pressure upon governments to spend more, rather than less. The concept of "austerity" will be banished to the history books, at least in the short term, and the governments' grandiose plans of "levelling the economic playing field", "building back better" and pursuing a "greener economy" will only be tackled through further blank cheques backed by nothing but a dubious promise of potentially fairer and more sustainable growth in the future. The simple truth is that if there are decisions to be made between spending on renewable energy and giving cash to the less well-off or tackling inflation, then the spending will be considered acceptable.

It's all in the mind

The other significant structural shift with regards to inflation could well be that expectations of inflation have risen. Whether it is the unmistakable wage growth that we can now see, or the impact of supply chains, or the growing demand for certain products, or the energy crisis that has pushed up our bills or indeed the very basic fact that each time one visits a shop everything seems to have become much more expensive, consumers and companies appear to have accepted that inflation is everywhere. As investors, particularly those that take inflation as seriously as we do, it is important to look through the next couple of quarters and think about the bigger picture and longer-term outlook. There are still many questions to be answered, but we believe we are staring down the growing reality that price rises could well be persistent. This is by no means certain and we will have to be "open-minded", and if the facts change, we will follow the advice of Keynes and "change our minds". But for now, our investment portfolios purposely carry a lot of embedded inflation protection. The interesting factor for us here is that, with most markets still priced for a prolongation of the disinflationary trends of the 2010s, if inflation does subside, then there's not much money to be made from taking that view, but it could come at a significant cost to those investors if inflation proves more persistent.

The dreaded word

Notably since our last quarter end update, many more references to the gut-wrenching word that we used, stagflation, have appeared. At the same time, many have dismissed the term, saying that we are not going back to the experience of the 1970s. We agree; the backdrop for the global economy is vastly different to that troublesome era. But will we see potentially turgid growth rates through this decade, as the world grapples with high debt loads, ageing demographics and an environment of less trust amongst major nations (another clear trend of the last few years and one which demands greater focus in a future update), alongside volatile and higher rates of inflation? While by no means a certainty, we view it is as entirely possible and worth being proactive about in our strategies. Indeed, we think the concept of a VILE outcome is real: namely Volatile Inflation and Low Economic growth. Is this a disaster for investors? No, but it is an investment environment that demands respect, increasing selectivity in one's investment choices and a portfolio that looks different to that which delivered "easy gains" in the predictable last decade.

Not all doom and gloom

Despite rising inflationary pressures, many asset markets have had a healthy period in 2021, although there has been a great deal of bifurcation amongst various markets, regions and sectors. In simple terms, it has been those assets that are perceived as inflation beneficiaries, as well as in equity markets those companies that fare well when interest rates rise that have performed best, with energy and banks towards the top of the leader board. Notably, most companies have so far been easily able to pass on the rising costs of inputs and wages to end consumers, leading to the widest profit margins recorded in history. This has been a real boon for investors in companies' shares, but the question must be "what next"? Will we see a continuation of this trend, or will elevated input costs and unmistakably rising wages erode the profits of companies who might eventually be unable to encourage consumers to pay more for their products? For now, at least, this question remains unanswered, and does make us more sceptical than most about just how well equity markets can fare if inflationary trends persist for longer than most expect.

Could companies help the economy and portfolios?

A major positive point for equities is that companies are sitting on a tremendous amount of cash from the profits they have gleaned in recent times. One factor we must consider is whether this could finally lead to a virtuous investment cycle, and companies spending more on research, development and training. That would be the best way to shake the global economy from its likely trend to low and unfulfilling rates of economic growth and could help reduce inflation in the long term. Of course, it could also contribute towards persistently high levels of mergers and acquisitions, aided by cash-rich private equity companies buying publicly listed companies, and lead to gargantuan corporate share buy-back programmes, which could help keep share prices higher than one might normally expect in a "stagflationary" environment.

Conclusion

The threat of a "stagflationary" environment is real and it is sensible to respect this possibility and prepare investment strategies to meet this challenge. While we still appear to be "dancing in the dark" and cannot say with certainty how the next few years will play out, it does appear that COVID-19 has potentially created sparks to start inflationary fires, and we must continue to monitor these threats. Hopefully the inflationary fears will subside, as most asset markets appear to be implying. As consumers and investors, we should hope that they do, but in our view the right approach is to hope for the best and prepare portfolios for the worst. The good news for all of us is that there is a diversified arsenal of investments to help us achieve our clients' aims and aspirations in the uncertainty ahead, even if inflation proves to be less "transitory" than the consensus expects. As we sit here today and gaze across the global investment landscape, we are excited by the range of exciting growth opportunities on offer and find comfort in specific protective investments that can support returns, should the current levels of inflation we are experiencing be a structural rather than a cyclical dynamic. We promise to keep you updated with our evolving views on this omnipotent subject.

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providing you with a variety of investment and market commentary.

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