TOREVELL &PARTNERS

Economic Background – May 2021

An accident waiting to happen[1]

The global growth outlook remains set for a period of synchronised global expansion through the second half of 2021 and into 2022. As the recovery strengthens, the key topic of conversation in company earnings calls and asset manager positioning is speculation on inflation and whether it will be sustained at current levels, go higher, or dissipate. Then if inflation is more than 'transitory' when and how will central banks withdraw their stimulus.

Running warmer

Economic news has been generally positive over recent weeks, suggesting the worst is behind us. In the US in particular the rate of expansion is impressive. In the recent IHS Markit PMI report highlighted that improving demand stemming from consumer confidence and the further reopening of the economy boosted companies order books.

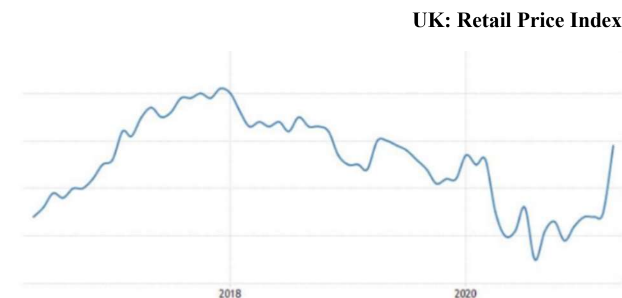
Manufacturers noted:

> *"order volumes increasing due to material shortages and efforts to stockpile amid rising costs." … "The steep rise in costs fed through to the sharpest increase in output charges since data collection began in October 2009, with record rates of inflation registered for both goods and services as soaring demand boosted firms' pricing power."*
>
> *IHS Markit*

This much-anticipated jump in inflation arrived in official figures in early May. The U.S. CPI numbers showed core prices increasing 0.8% in April, rising 4.2% over the last 12 months. Some of increase is attributed to higher energy prices and the low base effect of 12 months ago, but there were improvements in economic conditions and a return to pre-pandemic price patterns. There were also some surprising price increases. For example, used car prices were up 21% as a combination of factors contributed to rally in used-car demand. The inflation data was a surprise to many economists. The highest estimate for US inflation by the 39 economists posting on Bloomberg was 3.9%, so 4.2% was a big surprise to the upside.

This is not just a US issue. In the UK, the Retail Price Index rose to 2.9% in April, the biggest increase since June 2019 and above market forecasts. Factory gate prices of goods produced by the UK manufacturers increased 3.9% over the year in April 2021, the most since October 2018 and beating market expectations. Petrol products had the highest annual growth rate of any component of output prices (50.3%), driven by the very low prices a year ago. Business activity across the UK private sector expanded at a rapid pace in May according to the IHS Markit. CEO confidence is at an all-time high as concerns about the impact of the pandemic continue to fade. Unsurprisingly from the demand side of the economy hotels, restaurants and other consumer-facing services were strong, with gains reported across the board in all sectors. Given the strong economic output, orders, and optimism, we expect GDP growth to be sharply higher in the second quarter.

UK: Retail Price Index



Source: Office of National Statistics – Producer Price Index

In Europe, confidence regarding a recovery rose as signs of progress with vaccinations finally began to come through, helped by Covid-19 cases falling across the bloc. The composite PMI hit a nine-month high at 53.7, while the services PMI edged above 50. The

[1] U2, Who's Gonna Ride Your Wild Horses, Achtung Baby, 1991.

Economic Background – May 2021

European Central Bank maintained the increase in pace of the PEPP that was initiated in March due to concerns about rising yields. Producer prices in Germany increased 5.2% over the year to April of 2021, the biggest gain since September of 2011 and above market expectations. The main source of upward pressure came from raw materials and energy.

Policy

Minutes from the last meeting of the US Federal Reserve (Fed) indicated that the Fed might consider a plan for tapering the current stimulus if the economy continues to pick up strongly. Some participants also commented on the risks of letting inflationary pressures building up to unwelcome levels before they become sufficiently evident to induce a policy reaction. However, policymakers generally reinforced the economic recovery is far from complete and that inflation would move above 2% due to very low readings from early in the pandemic and transitory effects. After the transitory effects fade, inflation is expected to ease.

Not all are convinced, Lawrence Summers wrote in the Washington Post opinion piece titled "The inflation risk is real".

> *"Inflationary pressures are mounting from the boost in demand created by the $2 trillion plus in savings that Americans have accumulated during the pandemic; from large scale Federal Reserve debt purchases, along with Fed forecasts of essentially zero interest rates in 2021; from roughly $3 trillion in fiscal stimulus passed by Congress; and from soaring stock and real estate prices."*

Whilst Mr. Summers agrees that some of the pricing effects are temporary, there are other factors that could accelerate inflation as possible increase in demand from cash rich consumers outstrips supply. Over the last month we have heard from companies and fund managers who have mentioned that higher wages, regulation, and employee benefits have been welcomed, but they also increase business costs and ultimately prices.

The Bank of England (BoE) Governor Andrew Bailey told parliament that they are watching the inflation data extremely carefully and would not tolerate a persistent overshoot of inflation from its 2% target. But saw little evidence of this happening at present. The market was surprised by the departure of Andrew Haldane, the Bank of England's (BoE) Chief Economist, who is regarded as an optimist on the UK economy and inflation. Mr. Haldene explained his views in the minutes of last week's MPC meeting:

> *"There was now clear evidence that the economy was growing rapidly, with both household and company spending surprising significantly and persistently to the upside, and consumer and business confidence bouncing back." He warned that "there were good reasons for believing this strength in domestic demand would be maintained, including by the running down of the large stock of accumulated savings, leading to a larger and more sustained period of excess demand than was incorporated in the May central projections".*

Over the longer term, there are other cyclical factors. The global economy is reopening, with some countries further ahead than others. Globalisation has been a deflationary force for decades, but with protectionism on the rise, and more businesses diversifying, reorganising and reshoring vulnerable supply chains, that force looks set to weaken. Less globalisation, together with tariffs on trade and restrictions on technology transfers and investments, curbs inflation-diminishing competition.

Does it matter?

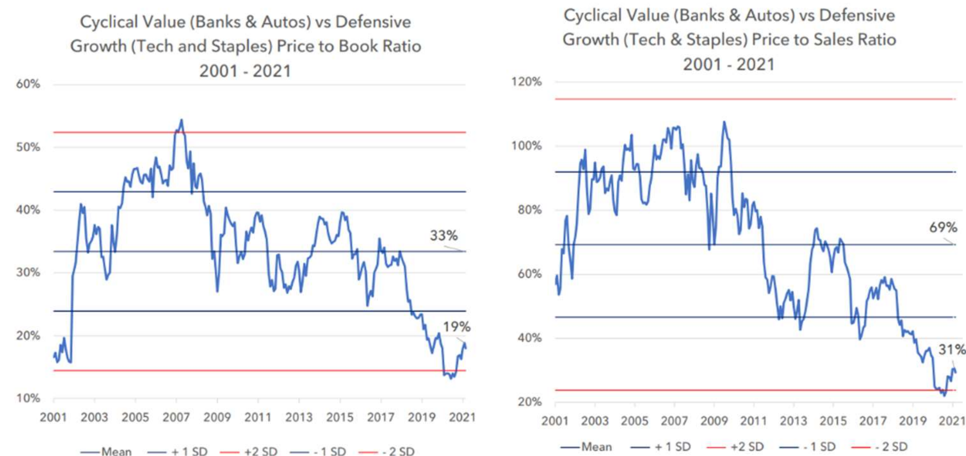
Does the rise in inflation matter? After all inflation is needed to reduce debt burdens and to unshackle the world from low growth, low productivity, quantitative easing and zero interest rate polices. For anyone who lived through or has studied the 70s and 80s inflationary environment, they know that the erosion of savings and high interest rates (on mortgage payments) will be particularly harmful. High inflation and the economic instability it brings also can lead to erosion of trust in the central bank / governments. Furthermore, there are other global factors to rampant inflation. Commodity inflation in emerging economies is particularly harmful and can lead to political and geo-political tension as we have seen in the past.

The concern within markets (not helped by central bank language), is that policymakers are actively looking to encourage inflation and that once the genie is out of the bottle, it will be hard to be put back in. A sustained rise in inflation will inevitably lead to a tightening of monetary conditions. A tapering of QE or a change in the interest rate pathway, will have a material impact on bond yields and equity market valuations.

Economic Background – May 2021

A Return to Valuation

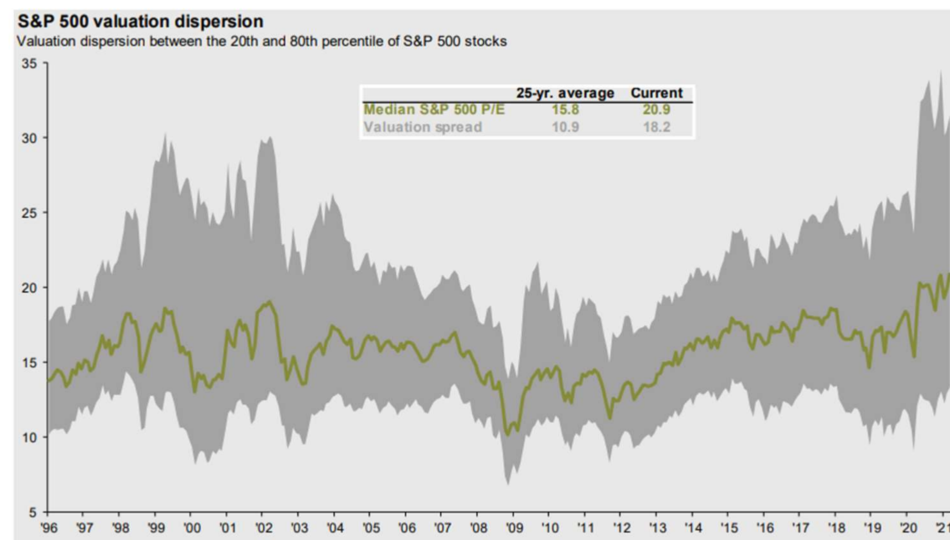
The rotation into cyclical sectors and recovery stocks was triggered by the announcement of the Covid-19 vaccines in November 2020. Since then, global 'Value' has outperformed global 'Growth' by 15% (6/11/20 – 26/11/21). Given the strength of 'Growth' of the last decade, it is tempting to believe that are due a pause. We spoke with Rob Burnett, fund manager of the Lightman European fund this month and he highlighted the two charts below. In the charts he is showing the relative differences between 'Cyclical Value' sectors to that of 'Cyclical Growth' using the valuation metrics Price to Book and Price to Sales.



Source: Lightman European, May 2021

The charts suggest that the recovery so far is relatively modest and that simply a return to the mean, will generate significant outperformance for Value focussed investors.

The spread in valuation multiples between expensive and cheap stocks remains exceptionally high as illustrated by the chart opposite, showing the valuation dispersion in the S&P500 between the top (100) and bottom (100) quintiles. As at the 31 March the price to earnings ratio (P/E) of the top 10 stocks in the S&P500 was 30x, which is 54% higher than the long run average of 19.5x. The remaining 494 stocks have a weighted P/E of 19.6x, which is 26% higher than their long-term average.



Source: JP Morgan, Guide to Markets

The last decade has been synonymous with growth and technology company share prices performing well. US indices have more Growth orientated companies and in particular Technology exposure, whereas European indices has a greater exposure to Financials, Industrials and Materials. Consequently, the US has seen more inflows of capital and Europe and the UK outflows. However, since November last year the leading performers in the market have been those in the more cyclical in nature – Materials, Energy, Financial and Industrial sectors. BlackRock highlight this point in some of their analysis:

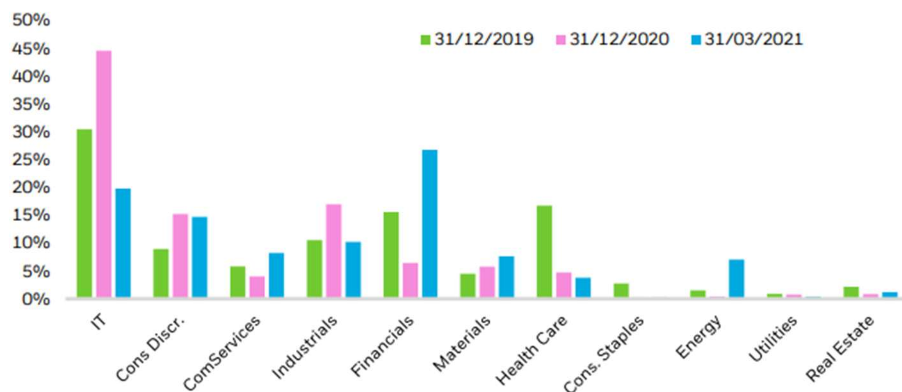
> *"As Value stocks appreciate, we're seeing greater overlap between Value and Momentum strategies, with Value building momentum and Momentum getting better value."*

> *"The dominance of IT companies in trend-following strategies has grown in recent years, to reach its highest level since June 2000 in mid-2020. This peak came off the back of the strong resilience of many tech companies*

displayed through pandemic sell-off and times of social distancing, as other sectors struggled. Today, the strong rebound and transition of many social distancing losers to restart winners has shifted sector weights within the strategies: tech allocations have shrunk significantly, while financials, energy, and materials names increased (see chart below). The mix of secular growers and stocks with high sensitivity to the business cycle makes the Momentum factor well-positioned to benefit from both the economic restart and long term market trends"

BlackRock, Factor Insights, May 2021

Sector allocations of Global Momentum strategies



We believe that timing markets remains extremely difficult, except with hindsight. Our focus is on constructing your portfolios with a balanced approach, combining managers that focus on Quality, Growth and Value, or a combination of all 3. Despite the behaviour of markets over the last few years we regard Valuation as extremely important. The future is uncertain, particularly the course of the recovery, inflation and the actions of central banks and governments. We have experienced an unprecedented event; the response has been huge, and we don't know yet how the massive build-up of debt will affect economies and markets moving forward. Given the uncertainty we would expect volatility in markets to stay elevated, certainly more than it has been over the 5 years prior to the global pandemic.

Chris Davis
Chief Investment Officer

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