BRIEFING NOTE

RIVER AND MERCANTILE

Key debates: prospects for a macroeconomic regime change and the implications for equity investors

September 2021

William Lough

"In paradigm shifts, most people get caught overextended doing something overly popular and get really hurt."

Ray Dalio, 'Paradigm Shifts' (July 2019)

Executive summary

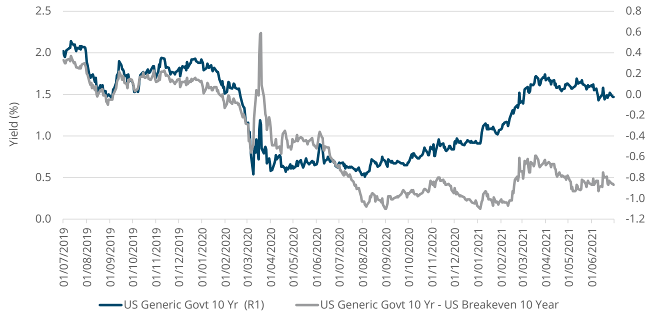
Central banks remain committed to accommodative monetary policy for the immediate future. Politically, austerity is out and fiscal policy instead now features commitments to societal levelling up and encouraging investment. Our central case is one of higher nominal growth with inflation that is higher than the recent past but not troublesome. This should favour cyclical companies. Due to investor positioning, the risks to the central view from a broader equity market perspective lie primarily in the 'right tail', that is higher, rather than lower, inflation. Our differentiated insight at the industry and company level – fleshed out in this paper via scenario analysis using real-world P&L structures – is that pricing power in such an environment would not be limited to the companies with which the average investor typically associates it today. Market participants are perhaps overconfident that pricing power dynamics in a benign inflationary environment are portable into an altogether different one. This is a potentially costly short-cut assumption, considering different valuation starting points and the varying impact of rising cost of capital.

1. How the macro-economic change could impact inflationary forces.

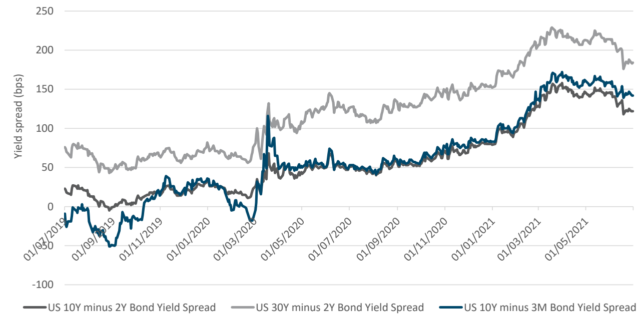
Over the last 12 months we have presented evidence that we were entering a reflationary phase, post a massive deflationary shock on the back of COVID-induced lockdowns. We suggested this should support the relative performance of cyclicals, small caps and the Value factor especially given their depressed starting points. It became increasingly clear and consensual that the global economy would experience a strong recovery as countries release restrictions and re-open for business, supercharged by the consumer's rebuilt balance sheet and plentiful government spending. Prices across multiple asset classes, and style or sector performance dispersion within equity markets, reflected this between mid-2020 and mid-2021, as shown below.

Chart 1. Performance of different instruments from immediately before Covid crisis until now

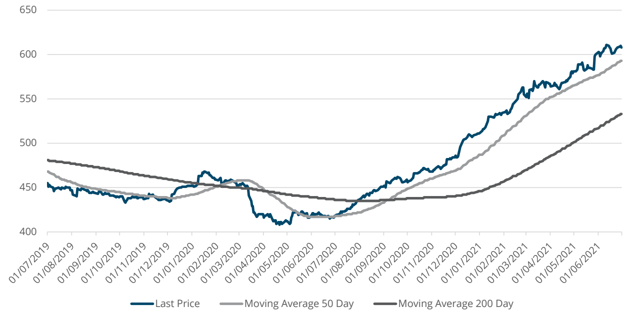
US 10-year bond yield (nominal and real)



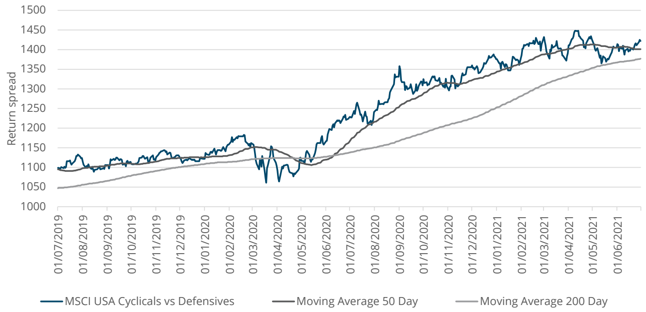
US yield curves



CRB US spot raw materials index



'The best economist I know' – Stanley Druckenmiller



Source: Bloomberg

This cycle already looks different to the last

Part of the challenge in financial markets is marrying up different time horizons. There are two sides to this: First, the sharpness of price moves and rotation in Q4 2020 and Q1 2021 particularly meant that there was some level of inevitability to the more recent pullback on the 'reflation trade'. What many investors are wrestling with is whether the reflation we have seen will be the start of higher longer-term nominal growth and, indeed, full-cycle inflationary pressures. Evidence is building, but far from conclusive, that the macroeconomic backdrop could be different to that seen by most of today's market participants in a handful of ways which have meaningful implications for performance between asset classes and specifically, within equity markets.

Major shift in developed market fiscal policy

What's currently proposed by politicians and central bankers implies a profound shift from how we have understood economic cycles since the 1980s. The policy choices of the post-GFC era are no longer politically acceptable, largely due to the impact they are perceived to have had on societal inequality. Instead, the Biden administration sees higher nominal growth driven by targeted "redistributive" fiscal policy as an opportunity to level-up imbalances in society and structural productivity declines in the economy.

This is evidenced by $1,400 stimulus cheques sent only to those earning below $75,000, while the American Jobs Plan or 'infrastructure bill' has repeated references to strengthening unionised jobs[1] and focuses heavily on social welfare spending as well as more traditional infrastructure projects[2]. Companies are being incentivised to invest and there is a realistic prospect the first proper private sector capex cycle, in 'smart industrial' and the longer-term mega trend of de-carbonisation above all, in a long time. Meanwhile, the Fed has said it won't 'get in the way' this cycle with tightening if inflation goes above target. This in itself suggests a change in mindset is required from investors, away from the experience of the post-GFC decade where, with governments more concerned about balancing the books fiscally, the global economy waxed and waned in mini-cycles based on central bank liquidity. To borrow an impactful phrase from a recent Exane strategy report, "If Biden gets his way, the 'peak-PMI' template may be obsolete."

Inflation is a distant memory

The other side of time horizons within markets is the way in which psyches or behaviours become embedded over long periods of time. Inflation is in almost nobody's muscle memory, and both the Fed and the White House seem comfortable that the disinflationary forces remain strong enough to be able to drive this durably higher economic growth through fiscal policy, without creating unhealthily high levels of inflation. In other words, Janet Yellen and co are asking "If previously we could not manage to sustainably reach 2% inflation with extremely high levels of employment, why are we not significantly ramping up targeted long-term investments in our economy to drive higher normalised growth?"

This is where risk management comes in. For the average portfolio, risk lies in the tail scenarios; we need to consider how likely these are and work out how we can protect against them. The central scenario might be higher nominal growth (including higher, but controlled, inflation), but within the tails of disinflation / deflation and high inflation / stagflation, the latter now appears as likely as the former.

On top of the $2.2 trillion CARES[3] Act, Congress passed a $1.9 trillion stimulus bill which was followed up with the 'American Jobs Plan' exceeding $2 trillion. For context, US spending during World War 2 was ~$4 trillion in today's money, so we are talking big numbers, and are in uncharted territory in many ways.

Some of the disinflationary narratives are also starting to see pushback. ESG trends appear in several ways to be inflationary – from near-shoring supply chains to better labour rights[4] (such as recent 'gig economy' legislation in the UK Supreme Courts). Then there is the large cost that corporates will initially have to foot to decarbonise and transition to a lower-emission economy. There is some evidence that at least some of this will be successfully pushed through to customers. For example, McKinsey showed that 60-70% of US consumers were willing to pay more for sustainable packaging[5].

It's therefore possible that in seeking to manufacture inflation, to borrow from Bernstein again, "policy makers could find that their fiscal and monetary support is going to magnify an underlying inflationary trend." Our companies are telling us that inflation is being pushed through the system. Yellen and Jerome Powell might be confident that the current inflation trends we're seeing are transitory, but when Stan Druckenmiller says, "For the first time in a long, long time, I'm actually worried about inflation", we should not dismiss it as a risk out of hand.

Not a central scenario, but impactful enough to affect portfolio construction decisions

Ultimately, we see a credible rationale for a sustained period of modestly higher real growth and above 2% inflation, implying nominal growth that is higher than the anemic experience of the past decade. This is supported by monetary policy remaining loose and being joined by a clear commitment to looser fiscal policy, as opposed to the counter-acting austerity witnessed following the GFC, from politicians. That being said, whilst it isn't a central scenario, we regard inflation remaining persistently high enough to create negative feedback loops to growth as a risk which now has elevated likelihood – so needs to be hedged within portfolio construction.

2. What do equity investors need to consider?

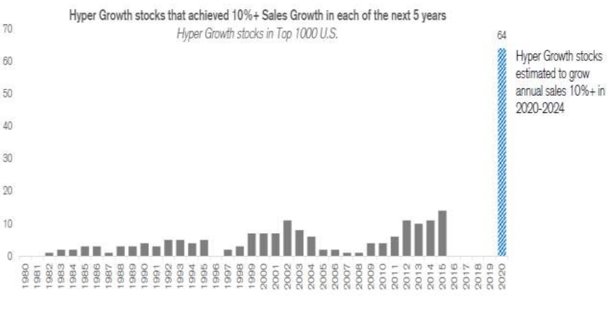
We think two important distinctions for equity investors in the environment we've described above are duration and economic sensitivity, or cyclicality.

The duration effect

The duration effect is relatively uncontroversial, as longer duration assets mechanically suffer at higher rates of inflation. In equity terms, of course, growth assets are long duration: most of the value sits at a distant point in the future. However, whilst government bond yields have all started to move up, with $13.4 trillion of negative-yielding bonds globally (from December's peak of $18.4 trillion), there is still a fair bit of runway. This has started to spark an overdue (in our eyes at least) debate about increases in cost of capital.

In normal – or positive cost of capital – markets, investors reward a combination of return on capital and growth. In the recent 'zero lower bound' (ZLB) environment with the cost of capital so low, investors and management teams alike have been willing to disregard near-term free cash flow generation in the hope of long-term domination of their addressable market. Some of these 'hyper growth' companies would be able to strategically pivot to higher profitability by reining in re-investment, albeit with a slightly smaller pie than investors may have been expecting the likely outcome, so the overall impact on their equity value will, perhaps, be muted. However, we would suggest that there are many more companies that have been classified as 'hyper growth' by the stock market, and valued accordingly, than will be able to live up to the hype. If history is anything to go by, as per the chart below, if financing of these 'disruptors becomes more discriminating, and ultimately more expensive, failure to meet elevated expectations will be a contributing factor to underperformance.

Chart 2. Performance of Hyper Growth Stocks



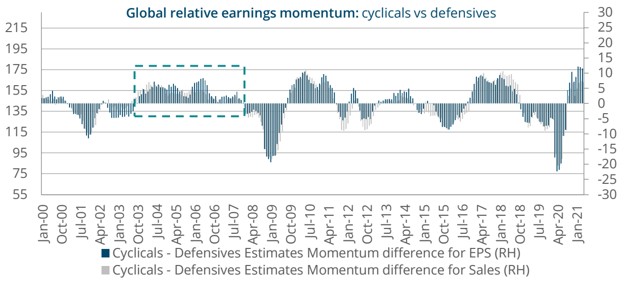
Source: Credit Suisse HOLT

Cyclical stock opportunities

Instead, we do still see opportunity in cyclical companies. This includes direct beneficiaries of higher interest rates, such as some banks.

Of course, commentary around value versus growth performance should not be treated as a rallying call to buy fundamentally challenged businesses. Cyclicals (or business cycle sensitives) versus defensives may be a more useful distinction than value and growth, based on the superior growth that cyclicals could deliver in a sustained higher nominal growth environment, relative to the outlook embedded in prices today. These cyclical companies will often also have higher operational leverage[6], particularly where the business model is more capital intensive – something we explore below. We look to the relative earnings revisions to particularly drive performance (top chart), in the way it did from 2003-2007 for example. Meanwhile the starting point for valuations in the companies we own or are buying still typically offers an attractive risk premium relative to history (bottom chart – shown for the US market).

Chart 3. Earnings momentum – cyclicals v defensives



Source: Redburn

Chart 4. US Style risk premia relative to history

Source: Credit Suisse HOLT

Ultimately, we expect the Value factor to act as a persistent support more akin to how it has behaved over the long term– than the headwind to performance that it's been for the last decade. The implications for the stocks, sectors and regions that are positioned to outperform in this environment are not necessarily the same as those that people have got used to over the last 10 years!

3. Stocks with pricing power that works with the new backdrop

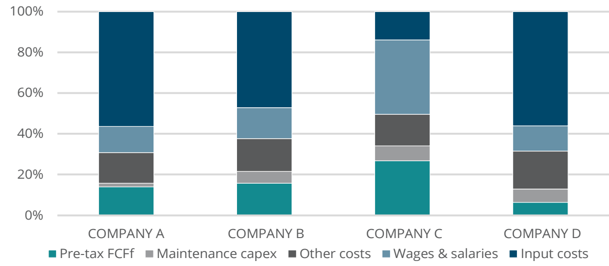
The most powerful determinant of company success in the economic and investment environments that we describe above, versus the environment of the recent disinflationary past, is likely to be the value of the competitive advantage provided by a well-invested tangible capital base. We should be looking for industries where market valuations still look backwards to lower return on capital of prior cycles, but where industry consolidation over the last couple of cycles will allow greater likelihood of pricing power in the coming cycle. A well-invested capital base should allow companies to 'harvest' cash flow without heavy re-investment requirements.

How to judge which companies will perform well if higher inflation does take hold?

We have a lack of real-world evidence from the past decades to understand how business models might behave if higher inflation does become embedded and we must therefore accept that imperfect information and 'first principles' are the order of the day. One way we can think about the issue is via worked examples. Below, we attempt to show this using four companies with varying P&L structures and what we perceive to be varying levels of pricing power. We have kept the company names anonymous as, while the exercise does use real numbers for the P&L structures, it is intended more as a theoretical experiment to explain how these behave under varying inflation scenarios, rather than as a precise forecast. The charts below highlight the different exposures to variable input costs versus more fixed costs, as well as different ongoing investment requirements over the intermediate term.

- **Company A:** specialty chemicals company with contractual pass-through pricing for raw materials and a well-invested physical capital base, meaning maintenance capex is running well below depreciation.
- **Company B:** vertically integrated paper & packaging company with pricing power due to a consolidated market, and a well invested physical capital base, meaning maintenance is running below depreciation.
- **Company C:** leading global technology and data company, with pricing power and strong structural growth characteristics and high re-investment requirements in intangibles.
- **Company D:** clothes and food retailer, with limited pricing power and relatively high reinvestment costs in both maintaining its store estate and catch-up spend on its online proposition.

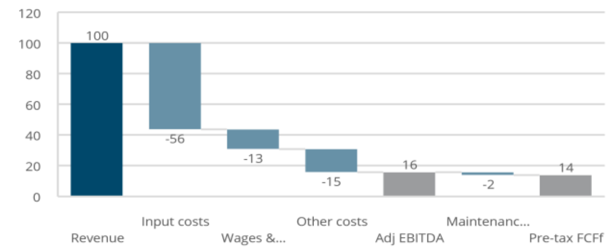
Chart 5. P&L structure – view 1



Source: Bloomberg, River and Mercantile Asset Management LLP

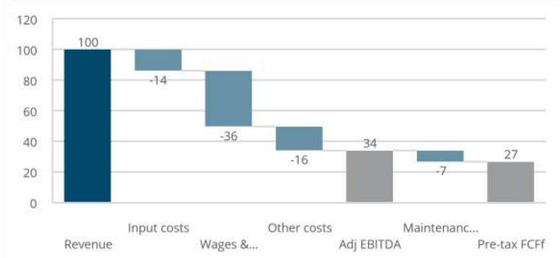
We can interpret the charts above as saying that Company A turns each $100 of revenue into $14 of free cash flow, while Company C, for example, produces $27 from the same $100 of revenue in a very different way. Of the four companies above, company C is today considered the highest quality – no surprise given the great margins and free cashflows – and is afforded the highest rating by the stock market. Company D is the weakest and on the lowest multiple. We can also visualise their respective P&L structure via the waterfall charts below.

Chart 6. Company A P&L Structure



Source: Bloomberg, River and Mercantile Asset Management LLP

Chart 7. Company C P&L Structure



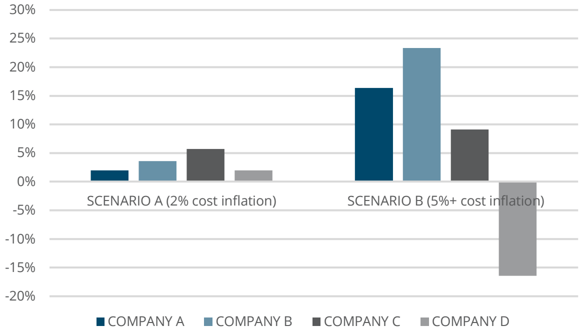
Source: Bloomberg, River and Mercantile Asset Management LLP

The exercise we have run is to look at 2 separate scenarios to understand what the change in free cash flow could look like in each – one inflationary and one disinflationary – in order to determine how investor preference might change[7]. **Scenario A** sees a benign inflation environment of 2% across all cost lines, similar to that experienced over the last decade or more.

Companies B and C, with their superior pricing power, are able to raise prices above inflation. Taking into account the cost structure, company C is ultimately able to grow its free cash flow at roughly double the rate of the others. This is clearly a valuable quality and has led to strong share price performance for those companies able to demonstrate these durable growth characteristics.

However, in **Scenario B** we assume that input cost inflation is 8% and wage cost inflation is lower at 4%, leading to overall costs rising ~5% on a blended basis. We start to see a material divergence versus scenario A – company A has contractual pass-through pricing on its raw material inputs and is able to generate operational leverage off the fixed cost base; company B has control of its raw material inputs via vertical integration and due to the pricing power afforded by a consolidated market is able to generate even stronger operational gearing by raising prices ahead of inflation; company C still has pricing power so is able to raise prices above its overall cost inflation, but due to its P&L structure it does not generate the same cash flow growth as A or B (with B now growing roughly double the rate of C); and D is unable to raise prices much more than overall wage growth due to the discretionary nature of what it sells and a lack of pricing power, meaning that its gross margins get eroded and free cash flow declines significantly.

Chart 8. Free cash flow -inflationary versus disinflationary environment

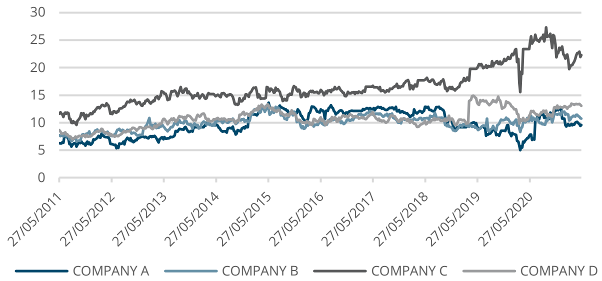


Source: Bloomberg, River and Mercantile Asset Management LLP

The lesson here is twofold: first, that the companies generating the highest earnings growth in this environment are not the same as those doing so in a benign inflationary environment; second, that weaker companies lose out big time in this environment.

In short, neither yesterday's winners (C) or losers (D) are the best place to be. Rather, our seemingly staid packaging company turns out to be a very attractive inflation beneficiary. This is actionable from an investment perspective because the stock market currently values these businesses in a very different way to the conclusions that we draw (see chart 8 below). In particular, it continues to look back at the winners of the last decade and still afford them a premium rating for what they achieved in that environment and the broad notion of pricing power. This valuation view looks vulnerable both in a relative sense (no longer the clear winners) and an absolute one as the duration angle discussed above comes into play.

Chart 9. EV/EBIT of Companies A, B, C and D



Source: Bloomberg, River and Mercantile Asset Management LLP

We posit that pricing power takes many shapes, and the optimal one in a higher cost inflation environment more likely involves vertical integration and a well-invested physical capital base, or put another way plenty of sunk cost and low re-investment requirements. We should be equally clear that even with low starting valuation, Company D would likely be a value trap in an environment where higher cost inflation was sustained, unless input cost inflation is matched by a boom in wages.

Closing thoughts

The hugely successful Manchester United F.C. manager Sir Alex Ferguson said, "You have to make decisions with the information at your disposal, rather than what you wish you might have. I never had a problem reaching a decision based on imperfect information. That's just the way the world works." Such is the nature of financial markets.

Some of the key allocations required in the different market regime described above might not have worked for over a decade, so investors may require a lot of convincing, or may lag their reallocations in response to evidence of sustained nominal growth and inflation. Market participants are still overcrowded in assets which demonstrated the best growth characteristics over the last cycle but are perhaps overconfident that the pricing power dynamics in a benign inflationary environment are portable into an altogether different one. We think this is a potentially costly short-cut assumption to make that, in Ray Dalio's terminology, could get you really hurt.

William Lough, September 2021

Footnotes

[1] *As does SFDR and Taxonomy documentation in the European Union.*

[2] *President Biden issued an executive order on 27 April 2021 increasing the federal minimum wage to $15 per hour. The last time the federal minimum wage was increased was in 2009, to $7.25 per hour. The 'American Jobs Plan' has over 25 references to unionisation and there is increasing public opinion forming behind a return to increased unionisation, which has fallen from 32% of US employment in 1950 to just 11% today.*

[3] *Coronavirus Aid, Relief, and Economic Security Act passed on 27 March 2020.*

[4] *President Biden issued an executive order on 27 April 2021 increasing the federal minimum wage to $15 per hour. The last time the federal minimum wage was increased was in 2009, to $7.25 per hour. The 'American Jobs Plan' has over 25 references to unionisation and there is increasing public opinion forming behind a return to increased unionisation, which has fallen from 32% of US employment in 1950 to just 11% today.*

[5] *https://www.mckinsey.com/industries/paper-forest-products-and-packaging/our-insights/sustainability-in-packaging-inside-the-minds-of-us-consumers*

[6] *The amount of profit that comes through for each incremental unit of revenue.*

[7] *Neither Scenario A nor B assumes any volume growth.*

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