Equity Investing for Inflation

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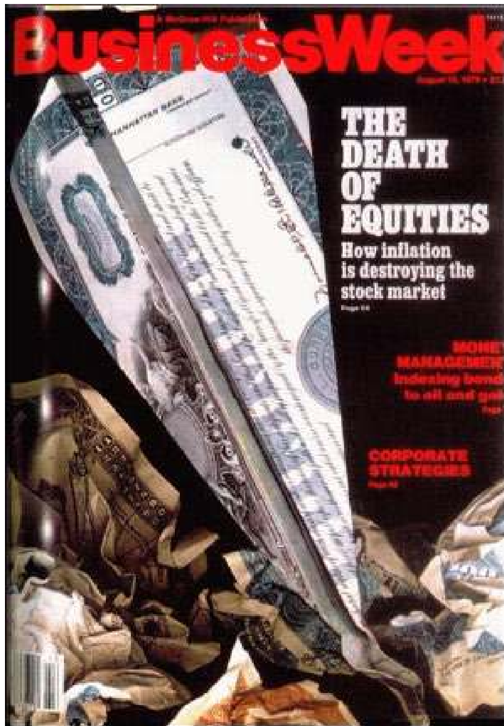
1. PROLOGUE

If we are sustainably moving to a world of higher inflationary pressures – if the pandemic driven lows mark the generational turning point for bond yields and inflation – it will pay handsomely to consider now what sort of investments will protect, or indeed prosper, in this new investment regime. Put another way, if savers – our clients – must once again worry about inflation eroding the real terms spending power after two decades of, let's face it, very benign conditions, what should they (and their advisors!) do about it?



40 years apart, compare and contrast. The 1980s was one of the best decades for equity investing of the last 100 years. BusinessWeek front covers, 1979 and 2019.

Source: Bloomberg BusinessWeek.

This note starts with a dollop of humility. For all the ink split, for all the PhDs theses and central bank posturing, no-one knows with certainty whether inflation is coming back or not. In fact, in all honesty as a society we don't really even understand all the mechanisms by which it might. Furthermore, asset price inflation, goods inflation and wage inflation are all intertwined in unclear ways. There are good arguments on both sides. It's important to acknowledge we, too, don't know. But we do acknowledge the possibility it *might* return, and this discussion takes place in that context. "What should we do if…", rather than "We should do this, because…".

One motivation for writing this piece, which collects together some thoughts I have had over the last few years, was recently coming across an article entitled "the best inflation protection for your ISA". Listed were a few commodity funds with gold exposure and the usual suspect quality growth names, "because they have pricing power". That may help but given these are assets which have profoundly outperformed over the last decade of *disinflationary* pressures it seems there might be a bit more to it than that!

It’s 40 years since the secular decline of inflation started in the early 1980s. 40 years is a very relevant timeframe because it is approximately a career, meaning there are few if any fund managers operating today with deep personal domain expertise of what investing through genuinely inflationary periods looks like. We are broadly back to first principles then, rather than being able to rely on personal investment experience, although we can clearly be informed by historical episodes such as the 1920s and 1970s, and also more recent short reflationary periods such as 2005-2008, 2009, 2013 and 2016.

Inflation is a catch-all term. Intuitively, though, it seems there is a big investment difference, for example, between inflation driven by a positive demand shock hitting a supply constrained industry, a 1970s style stagflationary malaise or a politically engineered currency debasement. Or a combination of these environments. It matters whether it is a global or local occurrence. As humans we love linear, single cause explanations and conveniently labelled phenomena – in the messy, incoherent and inconvenient world of investment we need to take care not to fall into this trap. Our ideas below, then, should be seen for what they are: a framework to potentially guide investment should these pressures return, rather than a shopping list for single stocks today.

One final point. The probability of a return or otherwise of inflation is a huge topic – and, as we say, beyond the scope of this note. We are here concerning ourselves with which assets should do relatively well *if* inflation returns. Readers will have their own view. All we would say is that the vast majority of investors are positioned for continuation of the investment environment of the previous cycle. If nothing else, the policy response and market message should be encouraging a reassessment of that positioning and at the very least a hedging of the current one-way bet. If history is a guide – starting with Emperor Nero having the first crack at quantitative easing in 54 AD by changing the silver content of his sestertii – when it comes, inflation normally punishes those who underestimate it rather than the other way around.

Nero on a Sestertius, 64-66AD
Source: vcoins.com

2. A CAUTIONARY TALE…

Hugo Stinnes c. 1924

Source: Wikipedia

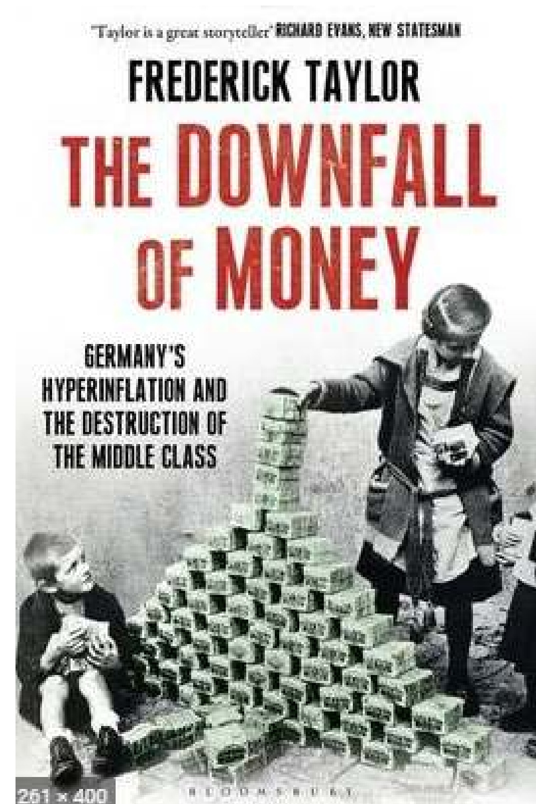
For me, one of the more credulity-stretching transformations in the European stock market of the last few years has been that of RWE, by some way Europe's biggest emitter of CO_2 from its dirty brown coal operations in Germany, into a latter-day ESG darling. Around 100 years ago in the previous roaring 20s (yes, that's a prediction!) the nascent *Rheinish-Westfälisches Elektrizitätswerk* was at the heart of a parallel corporate transition – this time with a focus on the 'S' part of ESG rather than the 'E' – at the hands of a certain Hugo Stinnes, a superbly successful inter-war German industrialist. He introduced the 8 hour working day, collective bargaining power, wage contracts and the right for employees to be included in corporate decision making – legacies which continue to this day in the German corporate sphere.

What does this have to do with investing in inflationary periods? The answer lies not really with RWE but with Herr Stinnes himself. He gathered immense wealth, initially using leveraged mergers to buy asset intensive businesses and then by creative cross-border currency arbitrage, although he would have used neither of those terms. By the age of 48 he had become the richest man in Germany and throughout the 1920s was known as the "King of the Inflation". This, as all GSCE historians know, coincided with probably the most famous and most studied period of inflationary pressure in history.

Stinnes started as a nobody, economically speaking – he didn't go to university, dabbled in retail then spent some time as a coal miner. However, he was the very definition of a pragmatist and, in a good way, an opportunist: his wealth came from dealing initially in coal, then iron and steel, and eventually pretty much everything else.

Play the cards right, and you can be a Hugo Stinnes. So can our clients. All you have to do is think differently and not just rely on what has worked previously because the consensus tells us to. Like most periods of investment regime shift, the 1920s were a function of a restless and unequal population at a time of global crisis forcing onto an overleveraged state (who couldn't and wouldn't pay down the national debt) a level of populism with the associated currency debasement and fiscal stimulus – or print-and-spend. Which, to draw another parallel, sounds familiar today!

The flip side of the coin through this inflationary period was the destruction of the Prussian administrators – the 'quality-growth' investors of their day. With prudence seen as a virtue, these well-educated, middle-class, low-risk savers – doctors, lawyers, accountants, professors were all wiped out while the swashbuckling Stinnes prospered. After 40 years of ever lower inflation and ever lower rates, and with the 60/40 equity/bond portfolio beating inflation year in, year out, and an enormous over-exposure to 'lowflation' assets and the secure growth style, I fear that unfortunately our industry has created a cohort of potential Prussian professors amongst our client base. In fact - whether advisor or fund manager, it's been a matter of survival to expose your clients to this style. Maybe it's time to change that…



Source: www.fredericktaylorhistory.com

The 1920s was an extreme period with a certain set of initial conditions which are unlikely to be repeated. However, the lessons are loud and clear, and still relevant. Inflation, if and when it comes, harms those who underestimate its effects and rigidly stick with received wisdom. It rewards the open-minded pragmatist.

3. INVESTING FOR INFLATION

To my mind, from first principles there are at least three characteristics which companies and stocks should exhibit to be beneficiaries of a more inflationary environment. Given we haven't seen such an environment for many years, this is a matter of open debate and other variables will no doubt become important as time passes. However, on a broad basis they should provide a relatively reliable exposure. The characteristics are:

Low duration

Asset intensive

Ability to pass through cost pressure

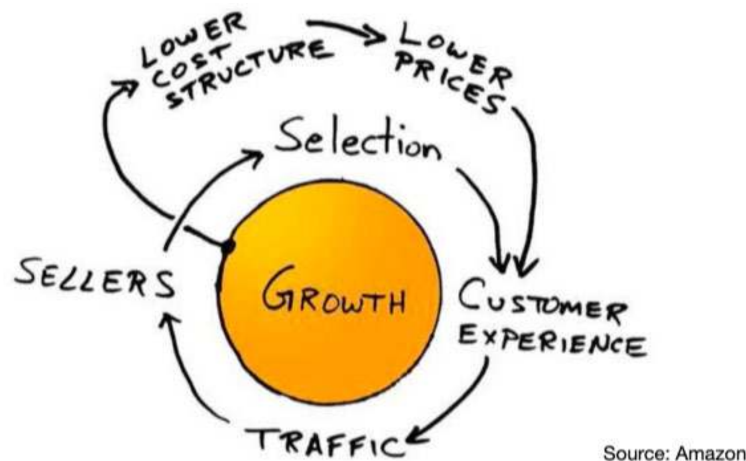
Let's look at what each of these factors look like in practice and explore why they should benefit from a regime change, at least from a relative if not absolute perspective. We should then consider the complex and perhaps unhelpful way these factors interact with each other… as ever making life a little more difficult for us as investors!

4. LOW DURATION

This is perhaps the least controversial. Ultimately, higher inflation by definition makes future money less valuable today increasing the discount rate. It also leads to a monetary policy response which involves the market forecasting higher future rates, a steepening of the yield curve and a consequent underperformance of duration. In equity terms, of course, growth assets are long duration: most of the

value is at a distant point in the future, which is predominantly why growth vs value is so highly correlated to bond yields. Deep value – for example, a stock on 5x earnings – derates much less when discount rates rise than a stock on 25x earnings, all else equal. This doesn't *necessarily* mean the stock will outperform in the medium term as the earnings from our exemplar value stock may collapse, but ceteris paribus it is a relative tailwind.

There is another more subtle point about why low rates and low inflation are very good for growth assets from a fundamental business perspective. Consider the Amazon flywheel[1].



Source: Amazon

Not even the most dogmatic value investor would argue that the investments Amazon has made over the years have proved, in hindsight, to be value creating (or if they do deny it out of stubbornness, you should politely but firmly show them the door: they lack the open-mindedness to be useful for our purposes). What is fair to say, though, is that it was only because liquidity has been so plentiful and rates so low that the market tolerated losses for so long from this company. This is what allowed Amazon to price its products below the incumbent bricks-and-mortar retailers, lose money every year, destroy the high street globally, and thus take market share to fund its growth model described above. When the cost of capital is above zero, the market normally demands dividends from its $100bn+ revenue companies, or at least a positive and reasonable profit margin, as in a higher rate environment the investment bird in the hand is worth two in the bush, rather than the other way around as it is today; a demand which has been famously lacking in Amazon's case, where the dividend policy can be summed up as "we will never pay a dividend".

If I now create a thought experiment where investors required a 4% dividend yield from the biggest company in the world – which would not be unusual – this large online retailer would have needed to make about an 8% margin (as offline retailers tended to before intense online competition arrived). That means prices would have been higher by a similar amount: 8%. This would make it much more difficult to undercut and take market share as well as allowing the bricks and mortar store more time to embrace and copy their way to online success. This has obvious investment implications around long term success, not just from the perspective of Amazon but more importantly for our deep value, low

[1] For simplicity I'm just considering the retail business here but the same conclusions can apply to the overall company including the AWS software business which is probably a more valuable component of the enterprise today.[2] Good for the typically more worker-intensive 'main street' incumbent, less good for the capitalist growth investor and 'progress'. Is all progress ultimately good from a societal perspective? A subject for another note perhaps… the perceived inconvenience of democracy amongst certain elites and current rise in populism suggests not everyone thinks so.

duration, disrupted, high-street retailer. *Higher inflation might actually lower the disruption risk in many industries* – for good and for bad,[2] but to the fundamental benefit of low duration (or value) stocks.

Amazon is just one salient example but the above analysis could just as easily apply to Uber and the minicab industry, Airbnb and hotels, Tesla and auto OEMs, Facebook and the advertising industry, Google and almost everyone else, Oersted and oil majors, Fintech and banks… the point is the cost of capital and ability to fund cheaply and at scale is a key input into the overall success of a franchise and those relative terms of engagement change as the cost of capital, and therefore duration, changes.[3]

Although as we have made clear when, how and if inflation is returning is really beyond the scope of this note – we are concerning ourselves with how to protect against the possibility – we have happened on an important and little discussed mechanism. In simple terms, the fact large scale companies can fund freely in the current environment to the point of selling loss making products (Tesla being a great example here), is actually *deflationary*; quite the opposite effect that cheap financing for businesses is supposed to achieve, according to the central banker's textbook (it is designed to increase capital expenditure which is *reflationary*).

In summary then the benefits of owning low duration – value stocks – in an inflationary environment goes beyond the hackneyed value vs growth argument, although that is the most straightforward part of it. There is a fundamental benefit to companies who are more disrupted, and therefore trade on below market multiples, if financing of the disruptors becomes more discriminating and ultimately more expensive as excess liquidity becomes less abundant. In fact, we've seen that there are ways in which lower-for-longer becomes a self-fulfilling prophecy which may need a shock or discontinuity – such as a war or, say, global pandemic – to jolt the investment environment into a different regime.

5. CAPITAL INTENSITY

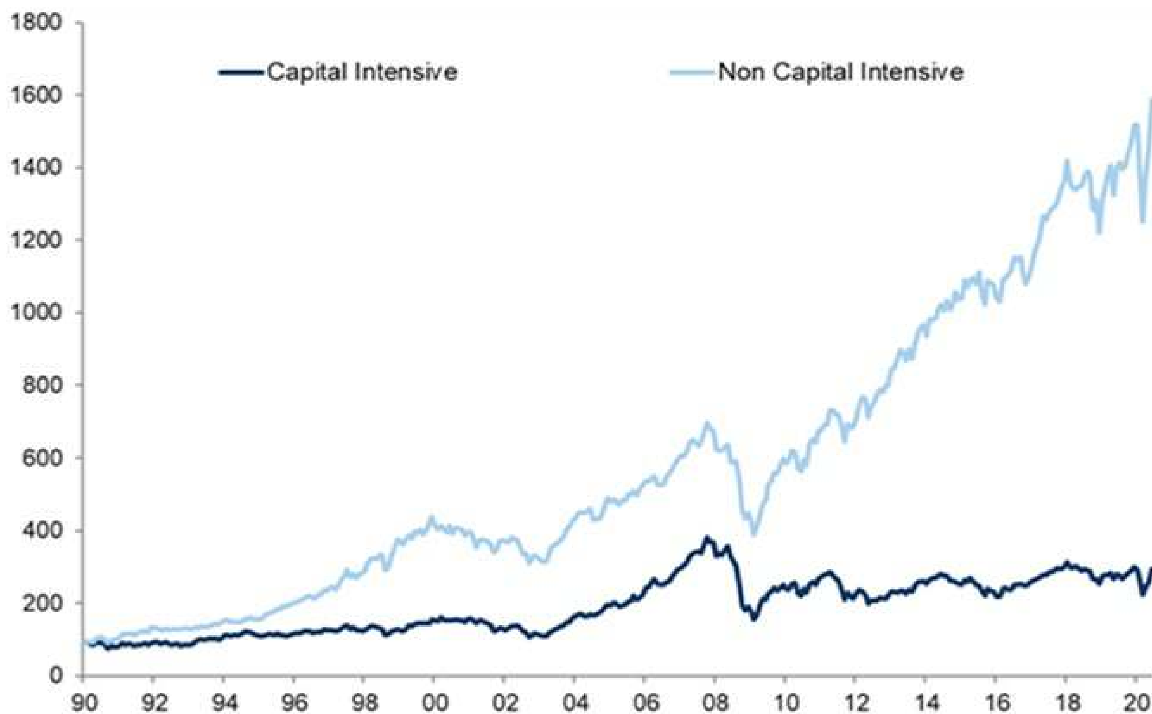
There became a real fetish for high return businesses over the last cycle, summed up in the chart below which is a slightly unusual way of displaying the outperformance of 'quality' business. High return or 'quality' is shorthand for high return on invested capital or ROIC, which is calculated as

$$\frac{Profit}{Capital\ Employed}$$

The easiest way of thinking about quality is to look for high margins which are often approximated as "good" businesses but as the equation above makes clear low capital intensity is just as important, which is why the outperformance of low capital intensity businesses becomes relevant.

[2] Good for the typically more worker-intensive 'main street' incumbent, less good for the capitalist growth investor and 'progress'. Is all progress ultimately good from a societal perspective? A subject for another note perhaps… the perceived inconvenience of democracy amongst certain elites and current rise in populism suggests not everyone thinks so.

[3] This is before we get into any discussion of tighter regulation or break up of industry monopolies.



Source: Goldman Sachs

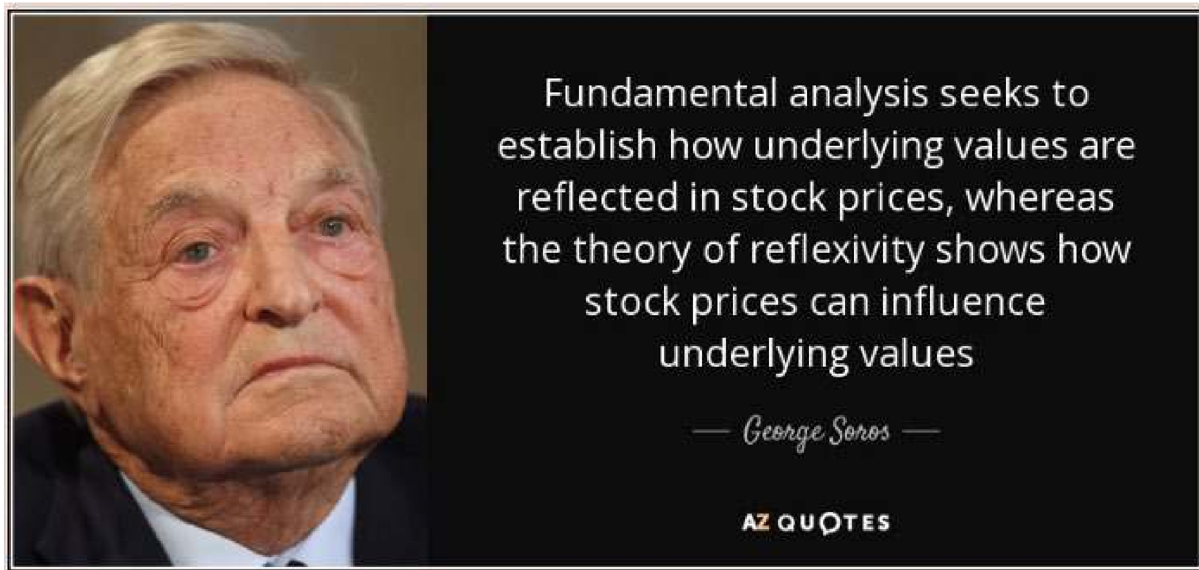
Of course, for the same price it goes without saying one would rather have a higher return business than a lower one where those returns are constant and sustainable, especially when that company grows. This preference is extremely fundamental – indeed it is axiomatic to company valuation.[4] So what does this have to do with investing in inflationary environments?

Firstly, in a way which tallies with our duration discussion in the previous section, this valuation preference becomes greater at lower bond yields and rates of inflation, which is at least partly the driver for the strong relative returns over the last cycle shown by 'quality', but low inflation also benefits low capital intensity business in an operational sense as we will discuss shortly which is why they were able to show better profit growth last cycle (and conversely why industrial and commodity businesses outperformed through the 1970s and 1930s), making the rerating they enjoyed justified from a fundamental perspective as well.

Before we look at why changing inflationary environments also benefit the profit trajectory of businesses differently, we need to consider the response of management teams and companies to this phenomenon – the rerating of high ROIC/ low capital intensity business. Students of George Soros will recognise the reflexivity herein. Because this characteristic – high ROIC or, even better, high and stable ROIC – became so highly prized over the last decade, companies eagerly sought to demonstrate it, with many boards including the measure or an equivalent in executive incentives. They attempted to demonstrate this characteristic to the market in a number of ways, whether becoming increasingly

[4] We won't go into the nuance of incremental ROIC versus historic ROIC, which is in fact the true way of assessing quality on a prospective basis and therefore valuation, because it doesn't add to the understanding of the variation of preference for capital intensity in differing inflationary environments which is the key variable we are considering.

capital light or moving to a subscription or aftermarket pricing model (which years ago was simply called the 'razor-and-razor-blades' approach).



Source: George Soros (2003). "The Alchemy of Finance", p.58, John Wiley & Sons

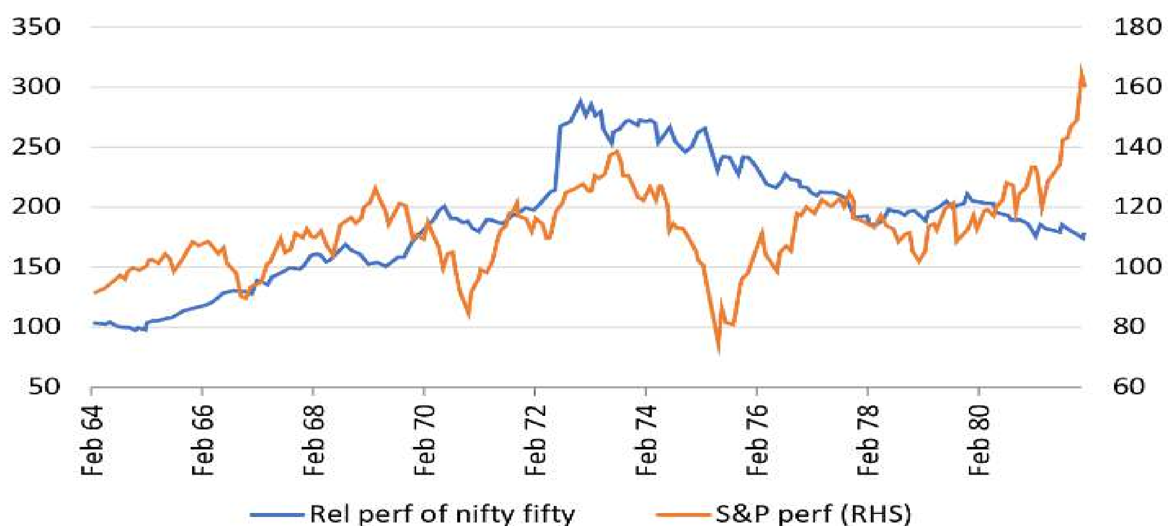
This led to higher valuations for those companies which undertook this endeavour, thus encouraging yet more businesses to follow. The unintended aggregate consequence of this preference for low capital intensity was a lack of capital investment or capex – which explains in part the difficultly for the European economy to achieve so called 'escape velocity' in the last cycle. Thus, we see another deflationary mechanism of lower rates at least in the short term although a lack of investment and hence supply constraints creating conditions for higher prices may prove to be inflationary in the more medium term as it was historically.

Source: Goldman Sachs

Now we come to the nub of the argument beyond the duration effect. In an inflationary environment we could expect this reflexivity to go into reverse. Not only because the relative preference decreases in line with our duration argument in the previous section, but also because suddenly the amount of sunk capital becomes a lead indicator of future revenues. Reading the Berkshire Hathaway letter to shareholders from the 1970s, one is struck by the preference for purchasing business which have this capital intensity (and, after lessons learned from the purchase of Berkshire Hathaway itself, had an element of pricing power to their businesses which we will come on to). This preference is especially stark relative to the Buffett of the falling inflation environments of the 1980s and 1990s which showed a much higher predilection for asset light higher return companies. In the 1970s Buffet himself talked a lot about the virtues of equity investment through the lens of 'investing today's dollars for tomorrow's return', which of course works even better when tomorrow's revenues are higher than expected because of (unexpected) inflation.

In fact, we have a very powerful analogue to tomorrow's potential environment from the 1960s and 1970s. Over this period as the world globalised the 'nifty fifty' of IBM, Coca Cola et al, were bid up to ever higher valuations which like today (but unlike the dot.com bubble) could be rationalised by forecasting a continuation of current trends. When the investment regime changed, starting with the OAPEC embargo on the US after the Israeli invasion of Egypt which saw the oil price rise from $2 to $8 a barrel, followed by large US deficits to pay for the Vietnam war and the breaking up of Bretton Woods these stocks consistently underperformed as more inflation protected assets derated less and delivered better earnings growth. "No-one ever got fired for buying IBM" was a phrase coined just before those companies went on to under perform for a decade. Today, no- one gets fired for buying FAANG stocks, for example.

The underperformance of secure growth in the 1970s



Source: Factset

So low capital intensity is preferred in a 'low-flation' environment, but higher capital intensity in a higher inflation environment. What does a business look like which displays the fundamentally optimal type of capital intensity to benefit from inflationary pressures? Clearly, we need a degree of sunk capital – an asset – from which to generate revenues at these new, inflated, selling prices. This could be a well invested factory, a fibre optic network, a forest or a mine. Theoretically it could also be an asset like a brand or drug patent, however for reasons we will come on to this is unlikely to work in practice. One way to assess this is in the operational leverage of a company which by definition, is higher in fixed cost businesses (i.e. the cost is fixed at the old, lower, prices). This is a less well trodden explanation of the underperformance of cyclicality (which has typically high operational leverage) in the low nominal growth world of the last cycle above – which provided less embedded higher margin future sales on lowly priced historically expended capital, beyond that attributable to the lack of growth displayed by these businesses.

Another characteristic we would like our inflation beneficiary to display in its capital base is longevity, which in accounting terms is captured (inversely) by the deprecation rate. It is much better to have an asset which needs replacing in 30 years than one which is replaced every 5 years, because we spend 30 years earning a return our cheap asset before, say, having to rebuild our factory at inflated prices. This is where assets such as brands or pharmaceutical R&D may struggle in this sense of sunk capital because they require continual investment (and because their pricing power is non-linear in an inflationary environment, which we will look at shortly).

One effect of the predilection for activities which allow for high returns has been the consolidation of many capital-intensive industries as management teams have sought to display the capital light characteristic so prized in the previous cycle. This, of course, confers a better degree of pricing power where the industry becomes sufficiently consolidated. It was exacerbated by the increasing technical complexity of many products, from the cutting edge such as lithography equipment to the seemingly mundane like wood pulping machinery. This is part of the argument of capital cycle investors such as Marathon Asset Management (the simple removal of capacity from an industry is positive, but the removal of a competitor has a potentially double effect through a better competitive dynamics). We will discuss pricing power in more detail below because it is the third key characteristic we need. At this stage, just bear in mind pricing power from capital intensive industries and companies should be better in any case in the future as the number of players has fallen for the reasons outlined.

In summary then, it stands to reason that a more capital-intensive business will do well in a higher inflation environment through a number of mechanisms. First, it can simply milk its assets for a number of years at higher selling prices. Secondly, there is a lower investor preference for high *historic* returns in an inflationary environment. Thirdly, stability of returns and revenues, and growth of them, is less highly prized. Fourthly – in a reversal of the reflexivity of the previous cycle – they should exhibit better pricing power, all else equal. Finally, and again somewhat reflexively, once capital intensity becomes a desirable asset more investment takes place which both requires the capital intense products these businesses produce and begets further inflation.

6. ICE CREAM, SMALL HANDS AND PRICING POWER

We started this note with the observation that many investors today – probably in line with their positioning in 'quality' stocks simply state that their portfolio's 'pricing power' is a sufficient hedge against inflation. We have made the point that although it appears to be a desirable characteristic, given

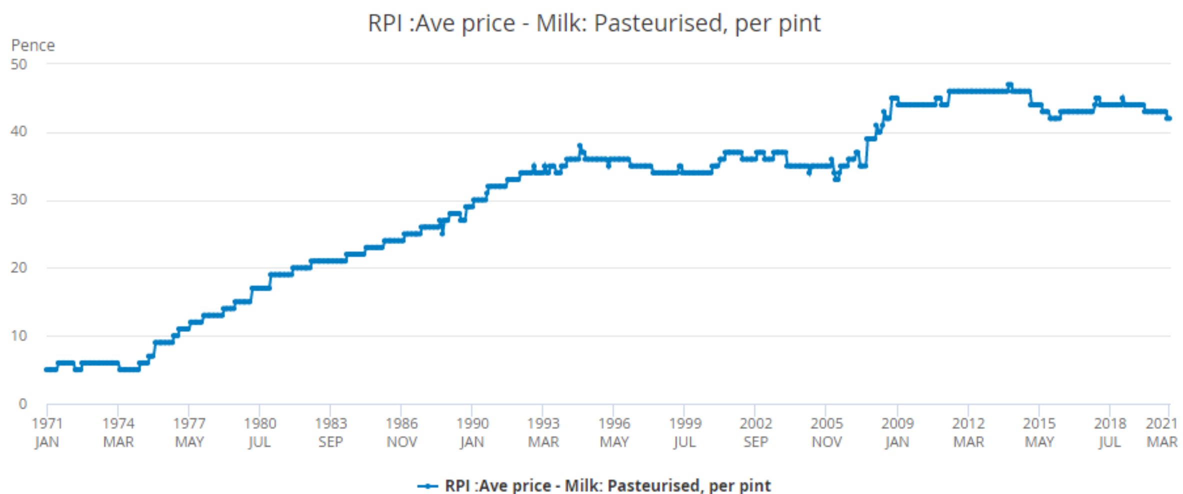
these businesses have profoundly outperformed over the previous cycle, there must be other factors at play. Given they have outperformed in a disinflationary period it must be, in fact, insufficient on its own to protect against inflation.

Hopefully the preceding two sections go some way to explaining this. As of today, most businesses which have demonstrated pricing power over the last decade (i.e. have raised prices more quickly than their costs which leads to margin expansion) are highly valued and hence long duration, and are often capital-light as well as being high-return businesses because the same market position which allows a company to raise prices also often allows them to push the capital requirements of the value chain onto other participants, in addition to the denominator effect on the ROIC calculation. This is the first issue to consider along the pricing power vector – these companies which display high pricing power also tend to show other, undesirable characteristics for inflationary investing.

It is self-evident though, that for the same duration and capital intensity, a level of pricing power is going to be preferred in the first instance as it indeed denotes an ability to pass on (inflating) costs. There are a couple of other considerations which should temper this view or at least give us pause, in the sense of what pricing power really means, which are well worth considering.

Firstly, pricing power is almost certainly non-linear across inflationary environments. This is a key reason why I believe assets such as branded consumer goods (and therefore 'quality-growth funds' which tend to be overweight) will not perform as well as hoped, should inflation come to pass. We've had a lot of heavy investment discourse so far, so allow me to illustrate this using the medium of ice cream…

I distinctly remember paying £1 for a Magnum ice cream as a 15-year-old teenager (funny the things which stick in the mind!) which now costs around £2.80 'at the van window', as they say in the trade. This gives a Magnum inflation rate of 4.8% - without accounting for I'm sure a degree of shrinkage in size – although maybe my hands have grown! We can contrast this 4.8% annual increase in the price of a Magnum with the key commodity input in ice cream, milk, which showed inflation of around 0.5% for the same 22-year period: I had the fortune of growing up in a disinflationary world. Although this analysis is not perfect as there are many other costs in the chain between udder and my small teenage hands, it does indicate the pricing power Magnum, or more specifically the owner of that brand, Unilever, has shown. This is demonstrated in their margin progression over time (data back to only 2006 as this is the earliest readily available) – a 650 bps margin increase to 2019.



Source: ONS.

Margins (%)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021e	2022e
EBITDA margin	16.4	17.4	17.4	17.1	17.0	16.4	16.1	17.6	19.6	17.1	18.8	20.8	21.4	22.9	22.3	22.6	22.8
EBIT margin	14.0	15.0	15.0	14.5	14.8	14.2	13.7	15.3	17.2	14.5	16.0	18.0	18.4	19.1	18.4	18.4	18.4

Source: CG Quest

What might this margin progression look like if the price of milk is going up at 5% per year in an inflationary environment? Is it likely that Unilever will be able to raise the price of Magnums 9.3% per year and shrink its size still further to maintain these historic 'jaws' and hence historic returns improvement? The power of compounding means the teenagers of today would end up paying £24 for a Magnum in 2040, when the price of a pint of milk would be about £1.20, in order to maintain the annual pricing gap Unilever has shown historically; and this during a period when real discretionary income is presumably under pressure from said inflation. It seems rather implausible to me: I think it's highly unlikely they will be selling many very small chocolate-covered ice creams at £24 to my university age children.

Source: Wikipedia

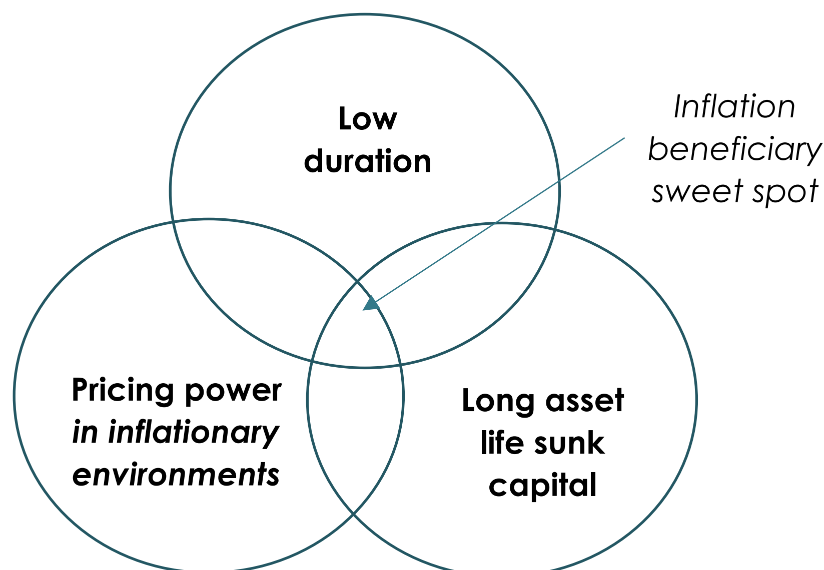
This non-linearity of pricing power undermines the key investment arbitrage for this type of stock, the so-called "beat the fade". The market prices the growth and returns for all companies to eventually return to the average (which at some point they must do, otherwise the company would grow to be larger than the economy). The skilful investor will identify those companies able to sustain that advantage for longer than is priced in. Ex-post, we can see that many 'brand' companies fell into this category at the beginning of the last cycle in 2009. However, I would argue that the conclusion of the previous discussion suggests this is unlikely to be the case in an inflationary cycle. I suspect this headwind will be particularly pronounced in consumer facing 'branded' stocks unless we see a substantial shift in the share of GDP from capital back to labour (the last 20 years has been one way traffic in the other direction) with the commensurate benefit to equality, which to be fair is an entirely plausible possibility given the current rise in populism.

Two further thoughts on pricing power. As we have already noted, because so many management teams have steered their businesses away from capital intense environments, and because the last cycle was quite tricky for lots of those more capital intensive businesses, causing some to go bankrupt or consolidate, the pricing power for many of these seemingly poor industries has been improved on a prospective basis. A good example is the European auto industry, where high single digit margins are not uncommon today – Peugeot have a target of 7% for example. In the recent past 3-4% would have been seen as a decent margin level for a mass market auto manufacturer. However, so poor were the returns and so lowly valued by the market were the companies' equity that even in protectionist Europe a large degree of consolidation has taken place. There are strategic challenges and prospective margin headwinds for those car makers who haven't invested in the electric vehicle revolution, for sure, but this improvement illustrates the point about easing competitive dynamics and the effect it can have on pricing power.

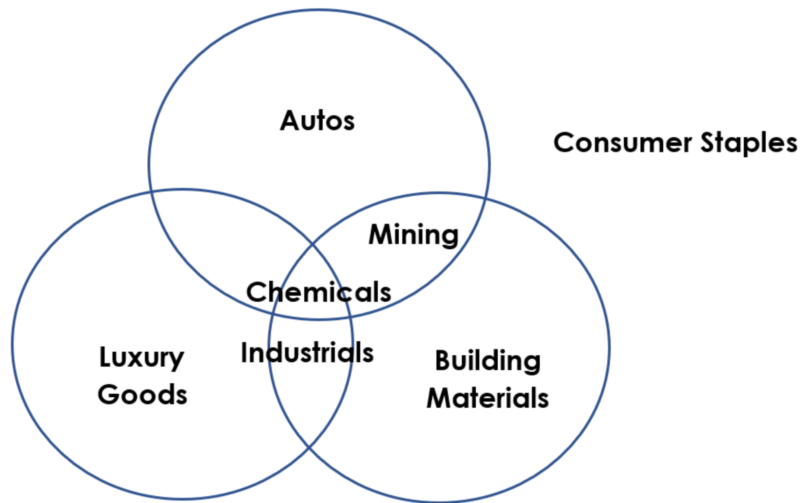
Additionally, in a reverse of the problem for the company whose business model is built on selling their brands at ever higher prices, many of the sort of companies that fit the bill from a capital intensity and duration perspective hover around cost of capital returns, such the steel industry or pulp industry. In this case, the effective pricing power is around 1 – whatever the input rises by so should the output, because there isn't excess profit to absorb the cost inflation before capital leaves the industry and players go bust, so marginal players increase prices to compensate. This isn't pricing power in the traditional sense, but it has a similar effect. Although this doesn't necessarily give a real terms benefit – all the industry can do is pass through the cost increases over the medium term – it should mean the nominal P&L increases in proportion with the broader inflation rate, which, depending on the headwind from the increase in the cost of capital, should certainly lead to a relative outperformance and possibly an absolute one.

7. SUMMARY

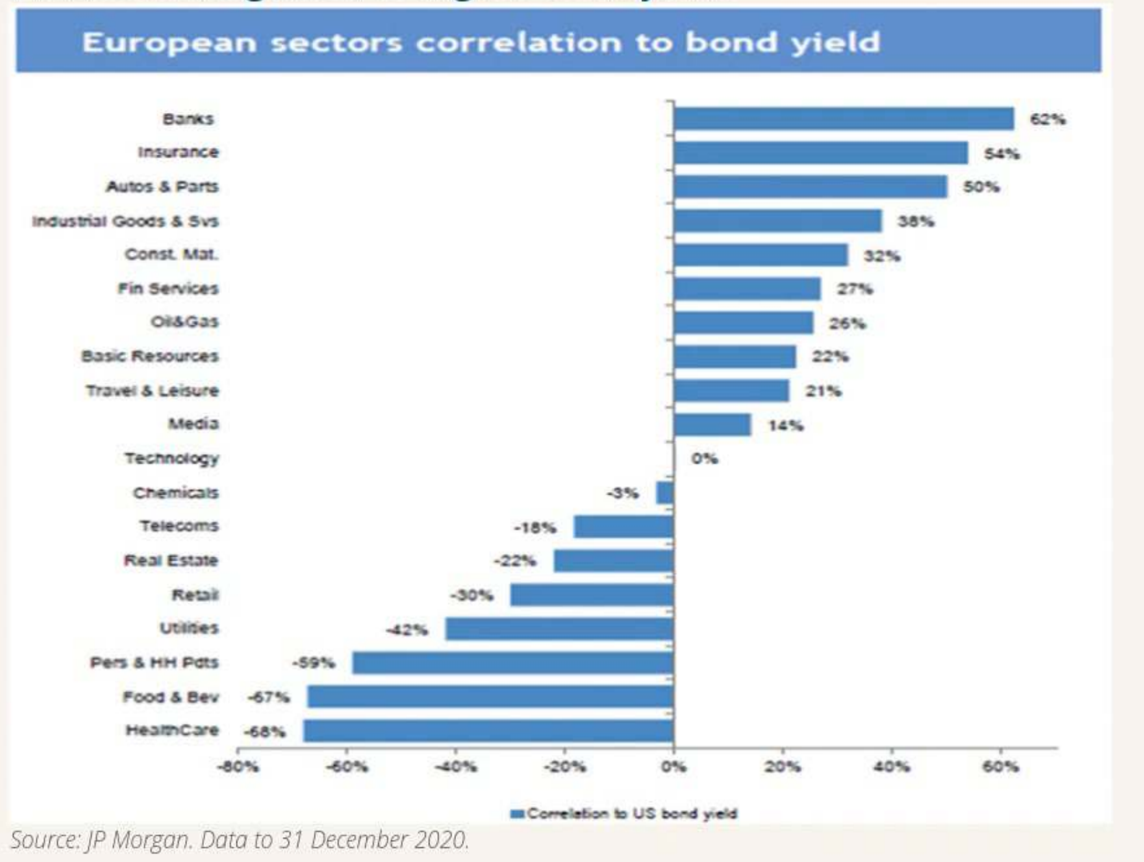
At this early stage, while inflation is still perceived and priced as a remote theoretical possibility, we have identified 3 broad characteristics which are likely to become much more highly prized in an inflationary environment. The first is low duration – 'value' – which is by now well-trodden as a beneficiary of inflation and vice versa. Although typically underweight, many investors do at least consider their exposure to value and growth. However, capital intensity and potential pricing power are two possibly even more important considerations which are rarely discussed. We are incorporating these factors in our security analysis and portfolio construction. There will be other characteristics which become important – for example is consumer, industrial or public sector exposure favoured? How will financials fare? What about geographical and currency exposure as presumably different geographies will suffer different levels of inflation and different policy responses. However, our 3 prized characteristics, which although they interact with each other in dynamic ways, can be simply summed up in another blast from my teenage past – the Venn diagram.



Let's try and place this in the real world – starting with some exemplar sectors as we judge them today. For brevity, I have included one per category but of course within sectors there is a range of valuations and business models. I am not sure there is a broad sector which fits low duration with pricing power, but asset light, (those stocks tend to be on high multiples) which is why there is not one shown.



We have approched this note in the main from first principles. That is because in regime shifts, previously well established correlations change significantly and can in fact mislead the slavish quantitative investment process to the wrong conclusion. That said, in support of our catagorisation above we can take a look at the current sector correlation to bond yield moves as a proxy for the market perception of the inflation protection characteristics of European sectors.



Source: JP Morgan. Data to 31 December 2020.

In the preamble, we were careful to caveat our analysis to broad characteristics which we should desire, if inflationary pressures return and we see an investment regime change. It is with caution, then, that I extend the analysis to stocks at this present time, however it is at least informative. I have used stocks currently held in the River and Mercantile European fund in April 2021, but of course we could look at the broader market. Whether, say, ASML as a company with undoubted pricing power even in an inflationary environment (it has a global monopoly) outweighs its high valuation is up for debate. The point is we are comfortable at a portfolio level that we own enough stocks nearer the centre of this diagram that the aggregate portfolio gives us reliable exposure to the sort of characteristics we want, without necerssarily being 'all-in' at this nascent stage.

We end as we started, on a humble note. Neither we, nor anyone else, really knows what the trajectory of inflationary pressures will be. On my side, I can see the *imperitive* for inflation – to sufficiently degear the economy relative to GDP such that debt level is bearable, and to address the growing,unsustainable and frankly unfair level of inequality we have reached between capital and labour, or rich and poor, or young and old. Fiscal policy has shifted dramatically. I can see the historical analogues and long-wave cyclical nature of inflationary pressures. In terms of actual evidence, we can also see the the short-term cyclical pressures as the recovery from Covid begins as well as the nascent pressures we were seeing on wages and capacity utilisation at the end of the previous cycle.

At the same time, the oft cited and well-trodden secular deflationary forces – debt, demographics and techonological shift – which have been attributed with creating the current investment regime are still in place and have even accelerated during the pandemic. It is entirely possible they overwhelm the nascent policy shifts and other reflation pressures. So we keep an open mind.

However given the outcome is so unusually uncertain, but the pricing of those assets which benefit from the change in regime is so attractive relative to the winners of the last cycle, it makes sense to start to incorporate them into portfolios, or at least create a framework to think about what we could start to look for. It is on that basis that we take this work forward then, with the intention to deepen our analysis of (and capital allocation to) this part of the market should the data support it.

James Sym

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