Absolute Return Partners

The Main Story of 2021 (other than COVID-19)

… and how you can take advantage of rising inflation

2nd September 2021

Agenda

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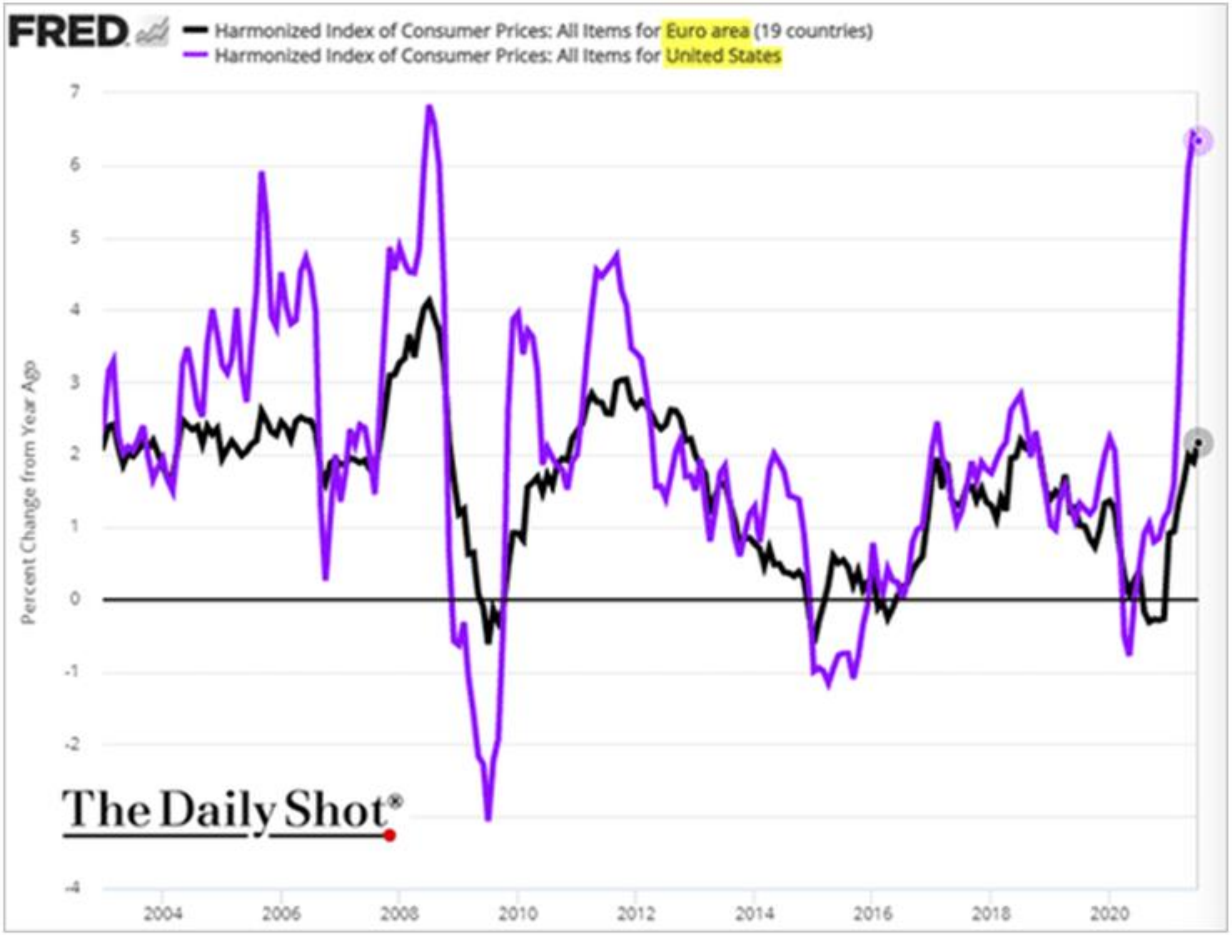
Part 1

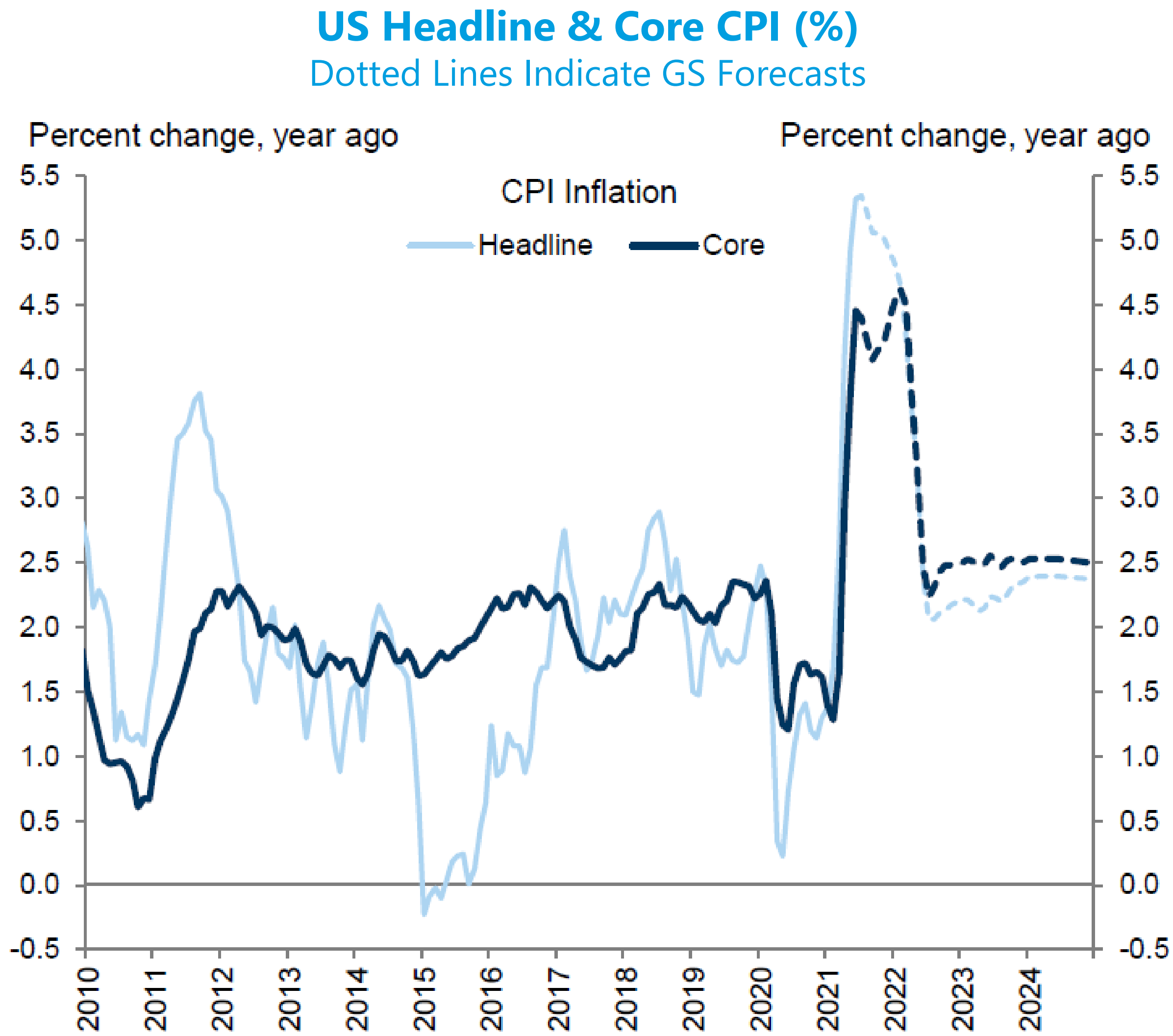
THE LATEST ON INFLATION

Consumer price inflation (CPI) is running much faster in the US than it does in the Eurozone.

US Core PCE Deflator, % YoY

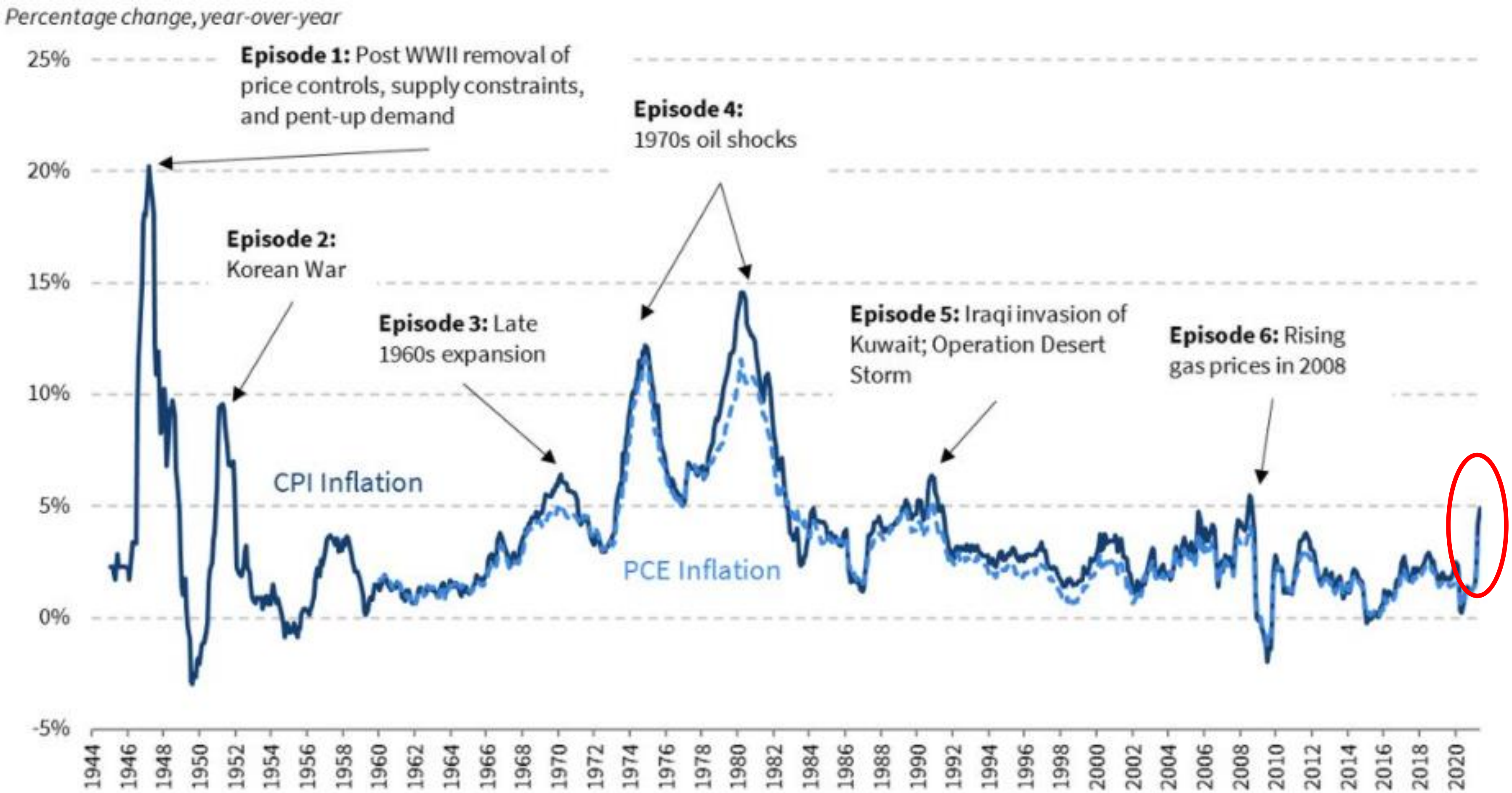


Core CPI in the US is now at the highest level (+4.23% YoY) since Iraq invaded Kuwait in 1991.



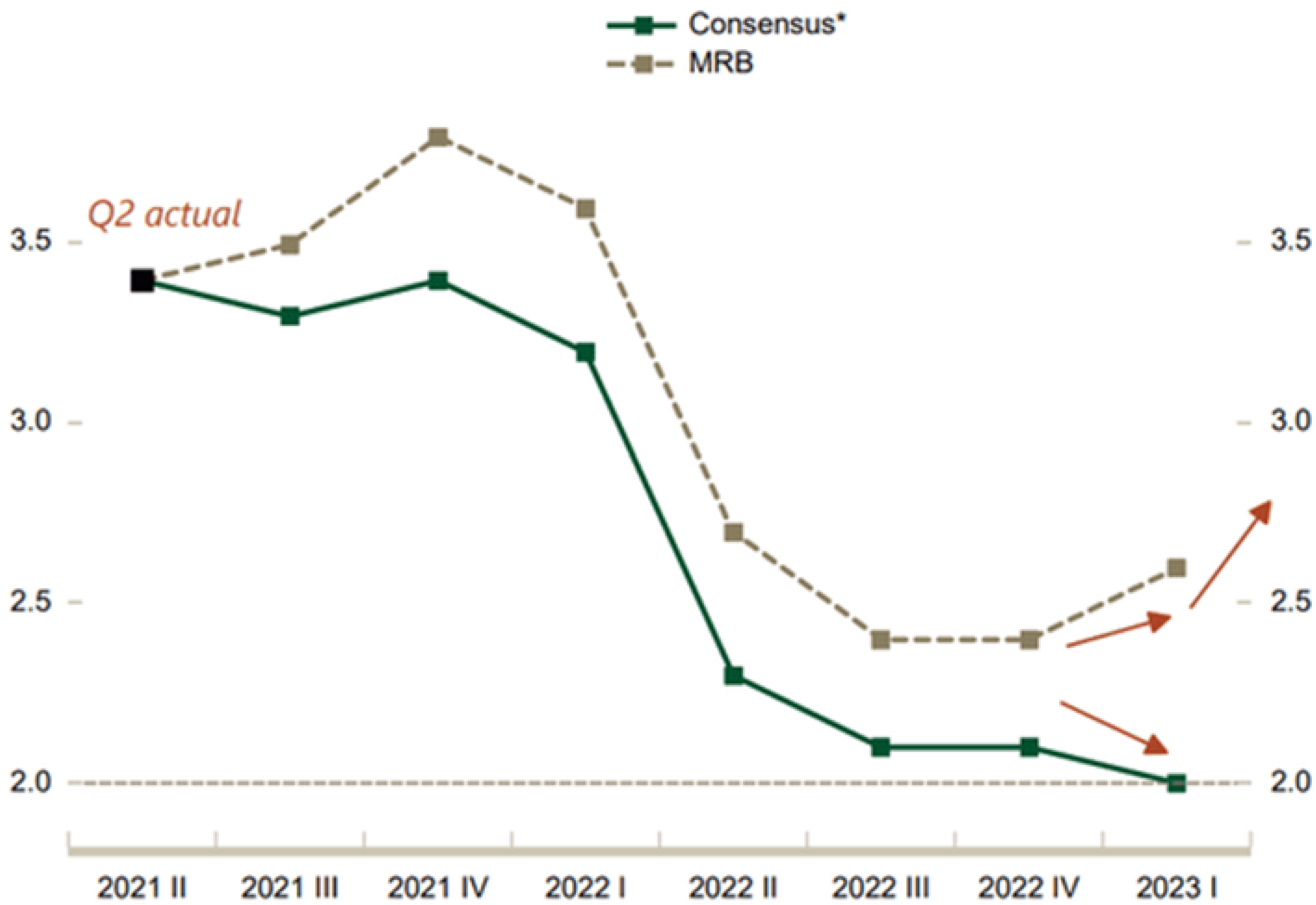
Since WW II, there have been six inflation 'episodes', leading to 5% or higher CPI in the US. The big question now is whether we are in for 'episode' #7?

US Consumer Price Inflation (%)
Post World War II



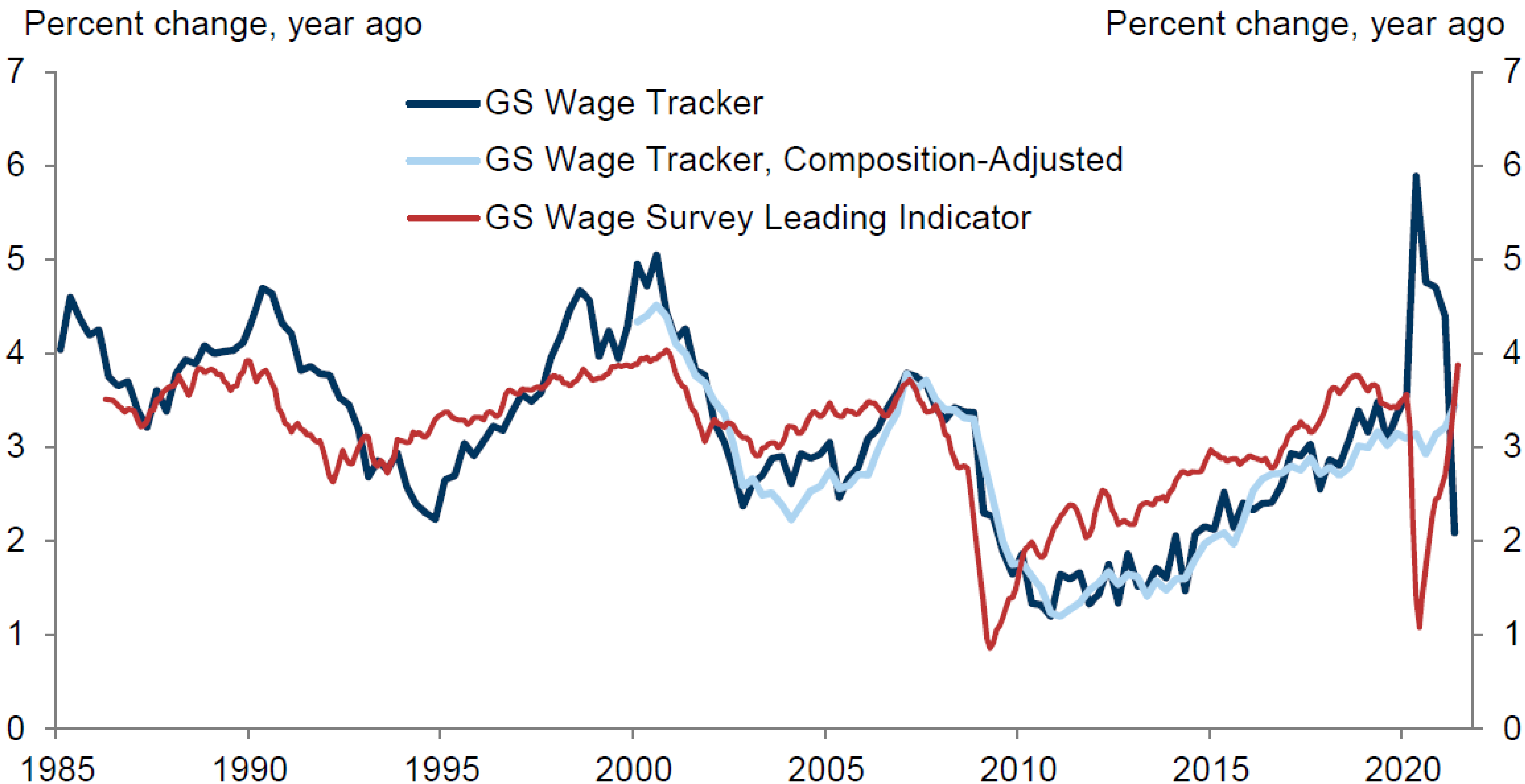
Consensus is that core inflation in the US will revert to 2% by mid-2023, but not everyone agrees. How will markets react if the consensus is wrong?

US Core PCE Deflator, % YoY



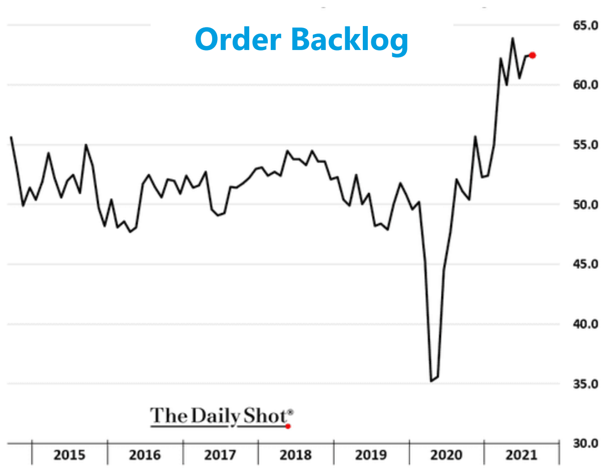
Goldman Sachs' wage survey leading indicator – now at the highest level since 2001 – suggests more upward pressure on US wages in the months to come.

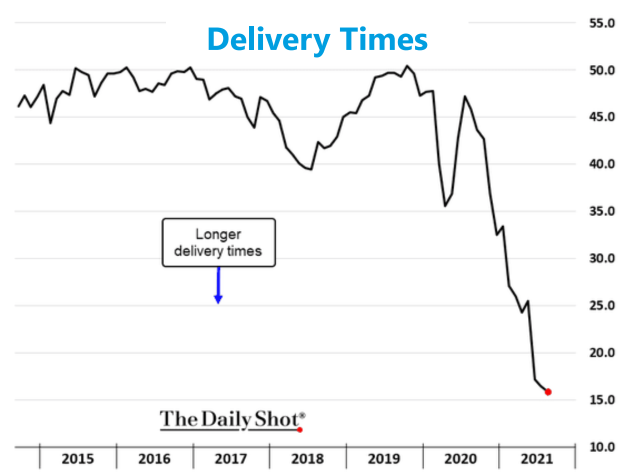
US Wage Tracker (%)
Actual and Leading Indicator

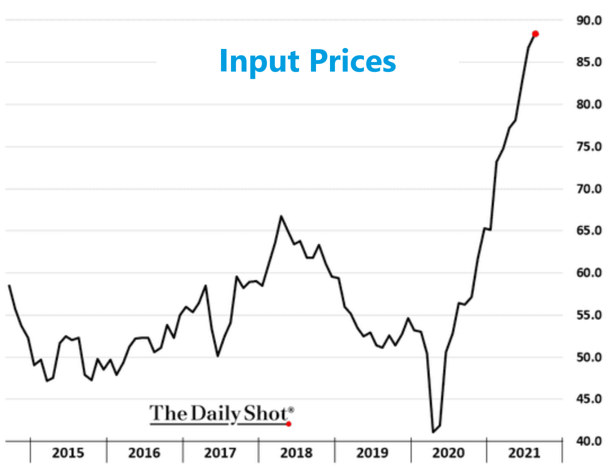


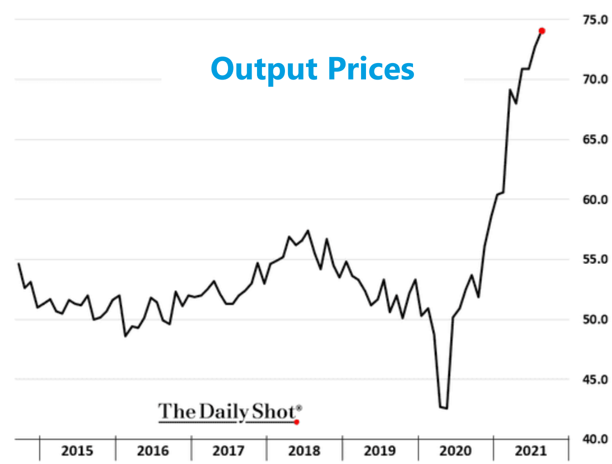
Rising order backlog and longer delivery times are leading to sharply higher input and output prices.

Markit US Manufacturing PMI





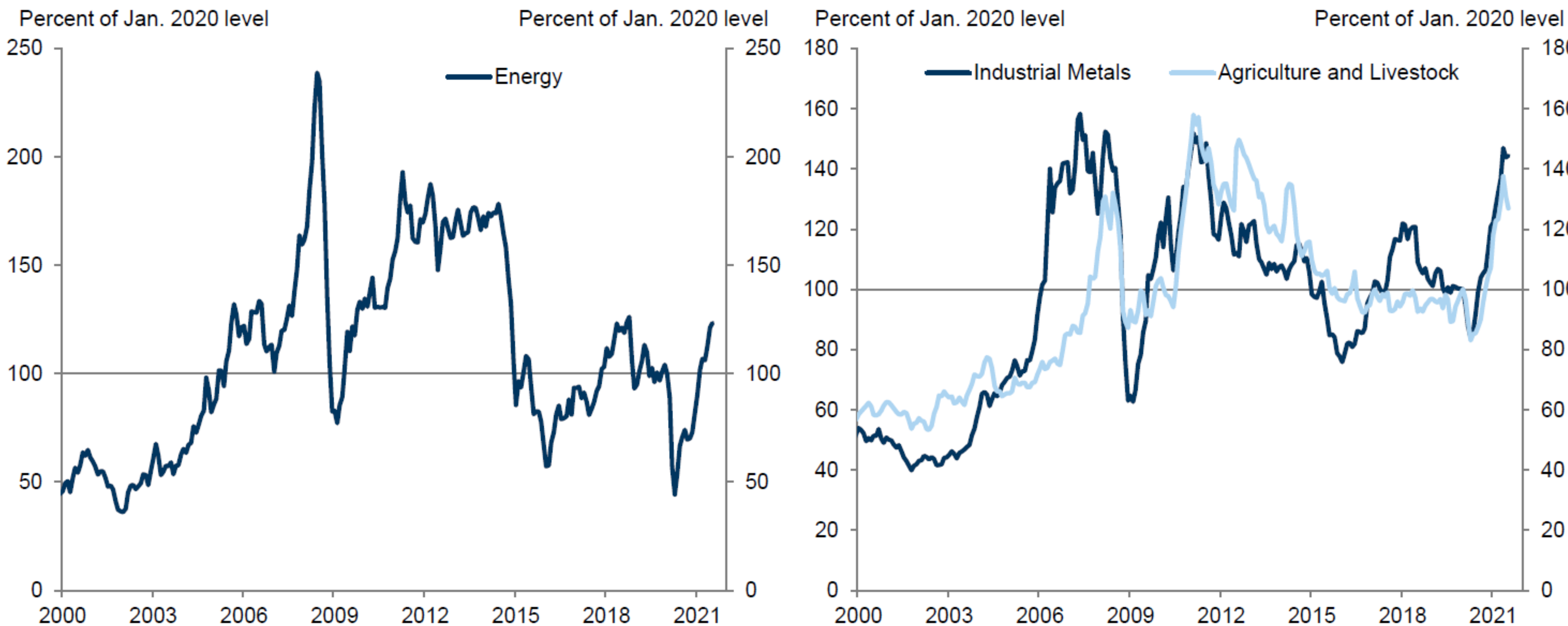




Energy prices are now some 20% higher than pre-pandemic levels and industrial metals prices almost 50% higher than pre-pandemic levels.

Energy and Industrial Metals Prices Since 2000

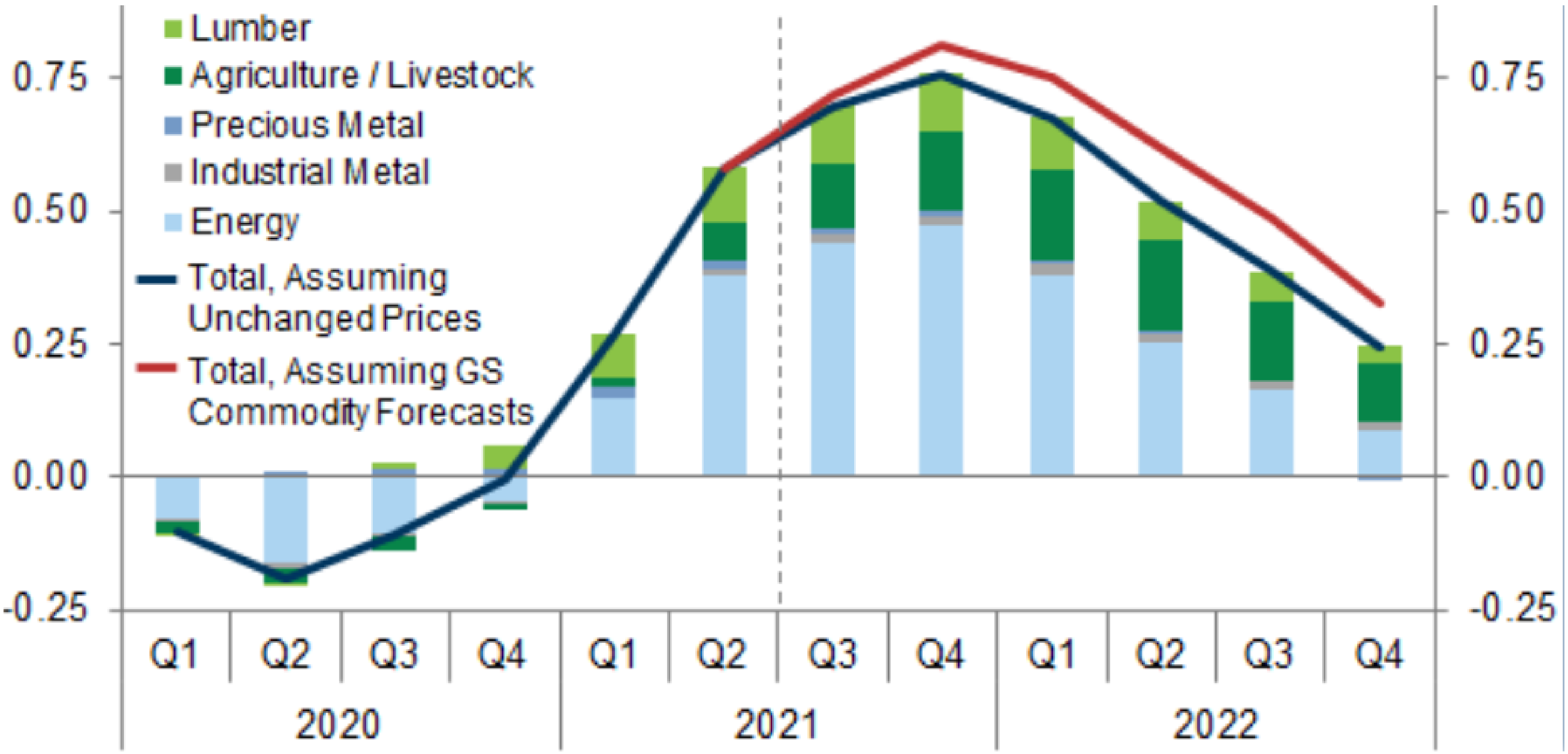
January 2020 = 100



Commodity prices alone are currently boosting year-on-year core PCE inflation by 70 bps.

Estimated Impact of Commodity Prices on Core PCE Inflation, YoY

Assuming Unchanged Commodity Prices Going Forward

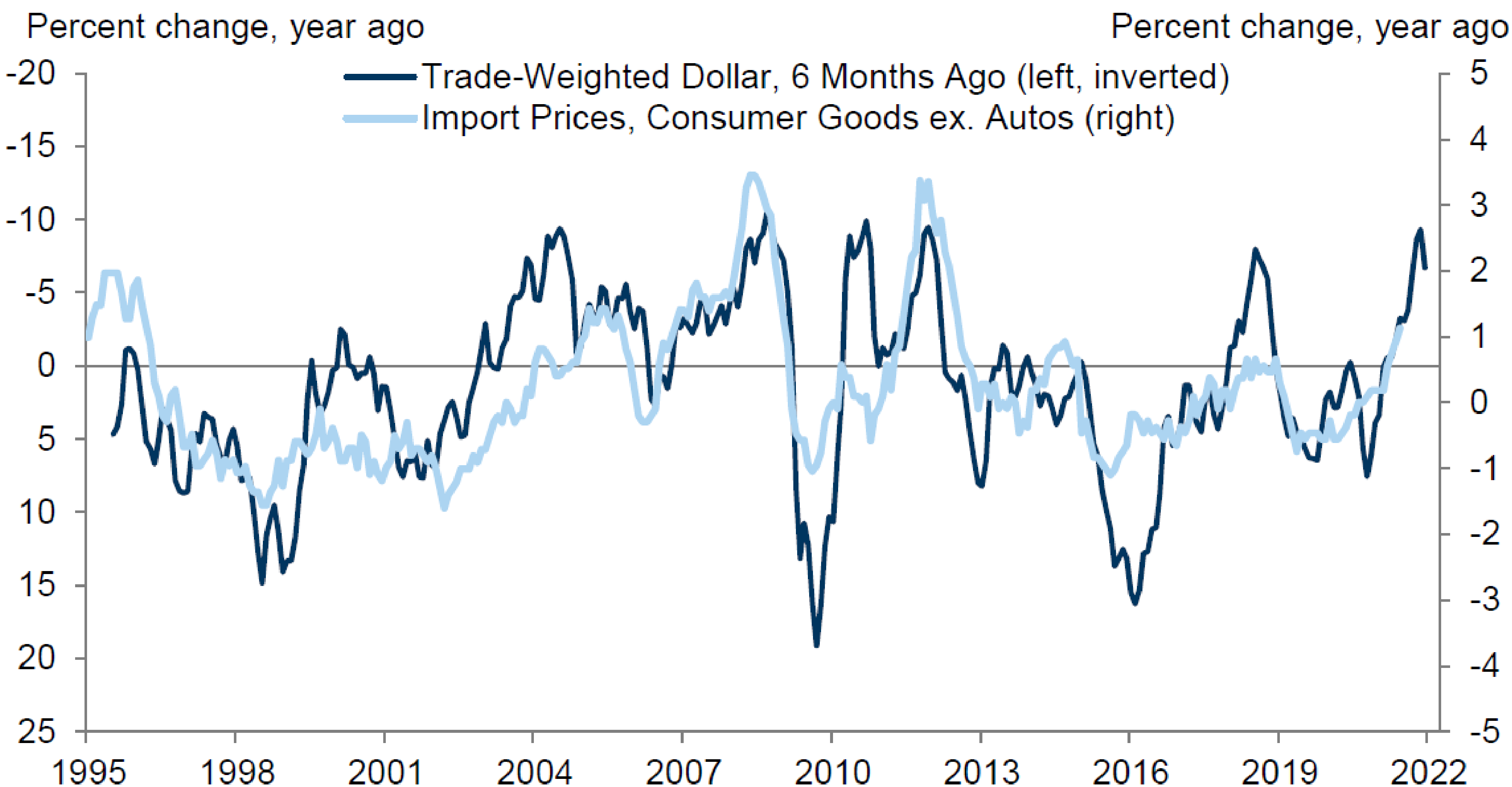


Booming shipping prices suggest that consumer prices may continue to rise a great deal more than 2% year-on-year for a while yet.

Baltic Exchange Dry Bulk Index

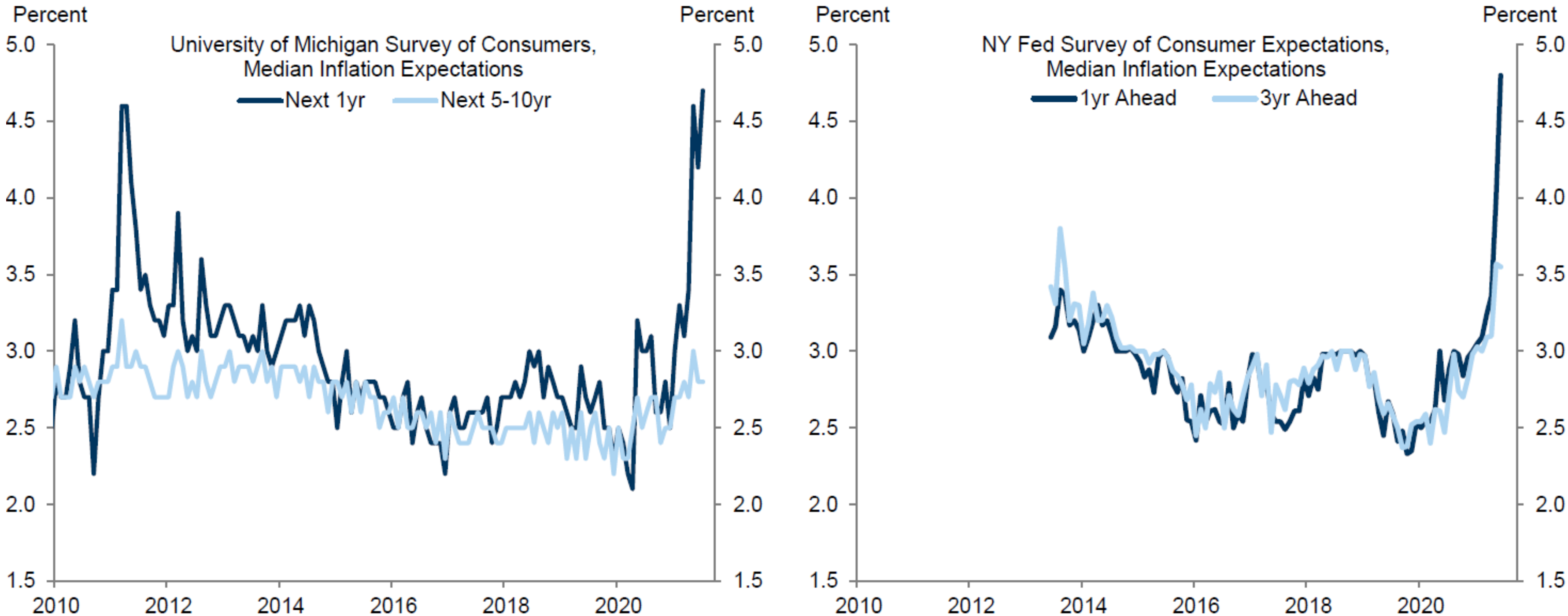
A relatively weak US dollar adds to the problems by putting further upward pressure on import prices in the US.

Trade-Weighted US Dollar vs. US Import Prices

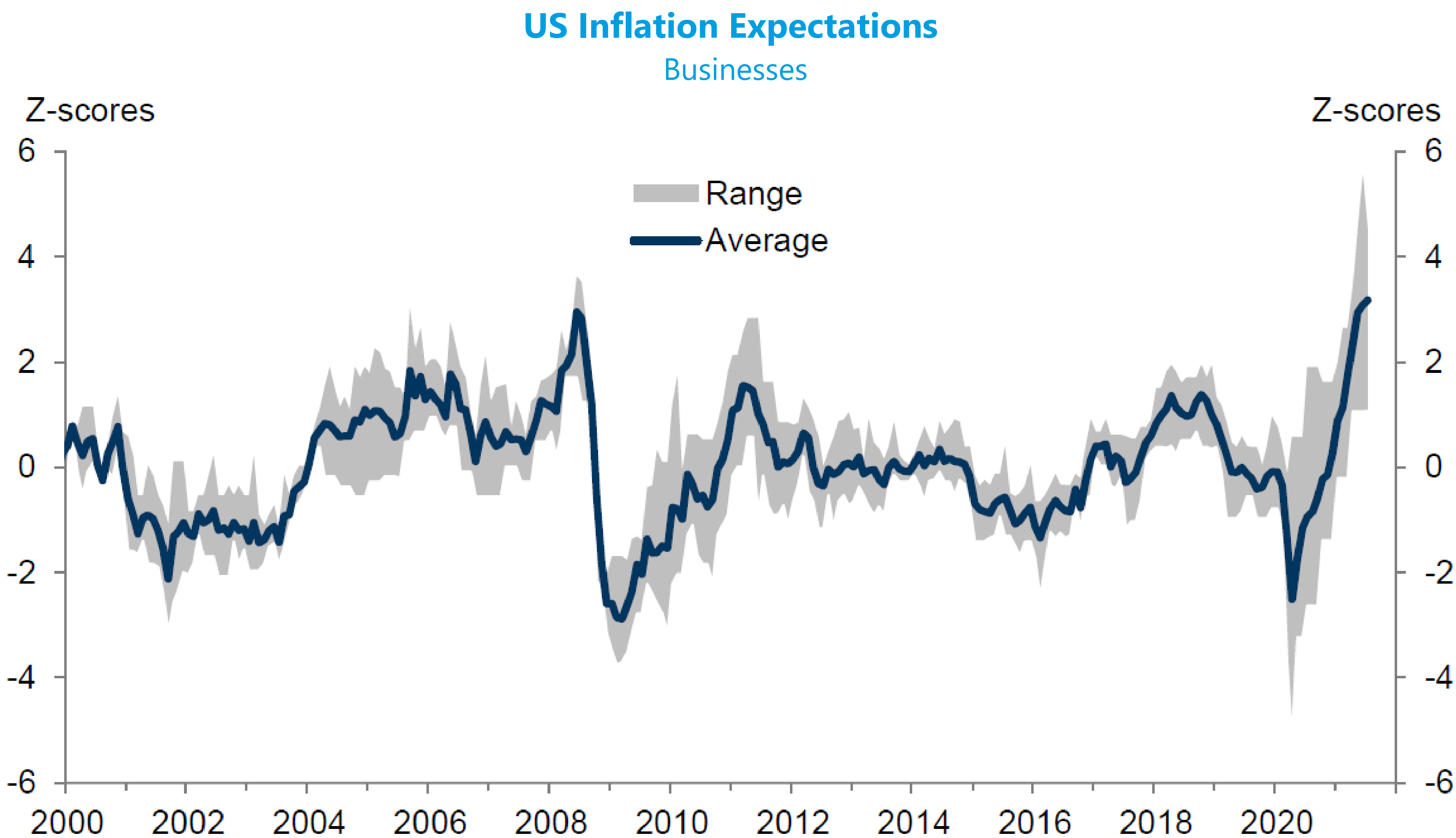


Most worryingly, inflation expectations are rising, both amongst consumers …

US Inflation Expectations
Households



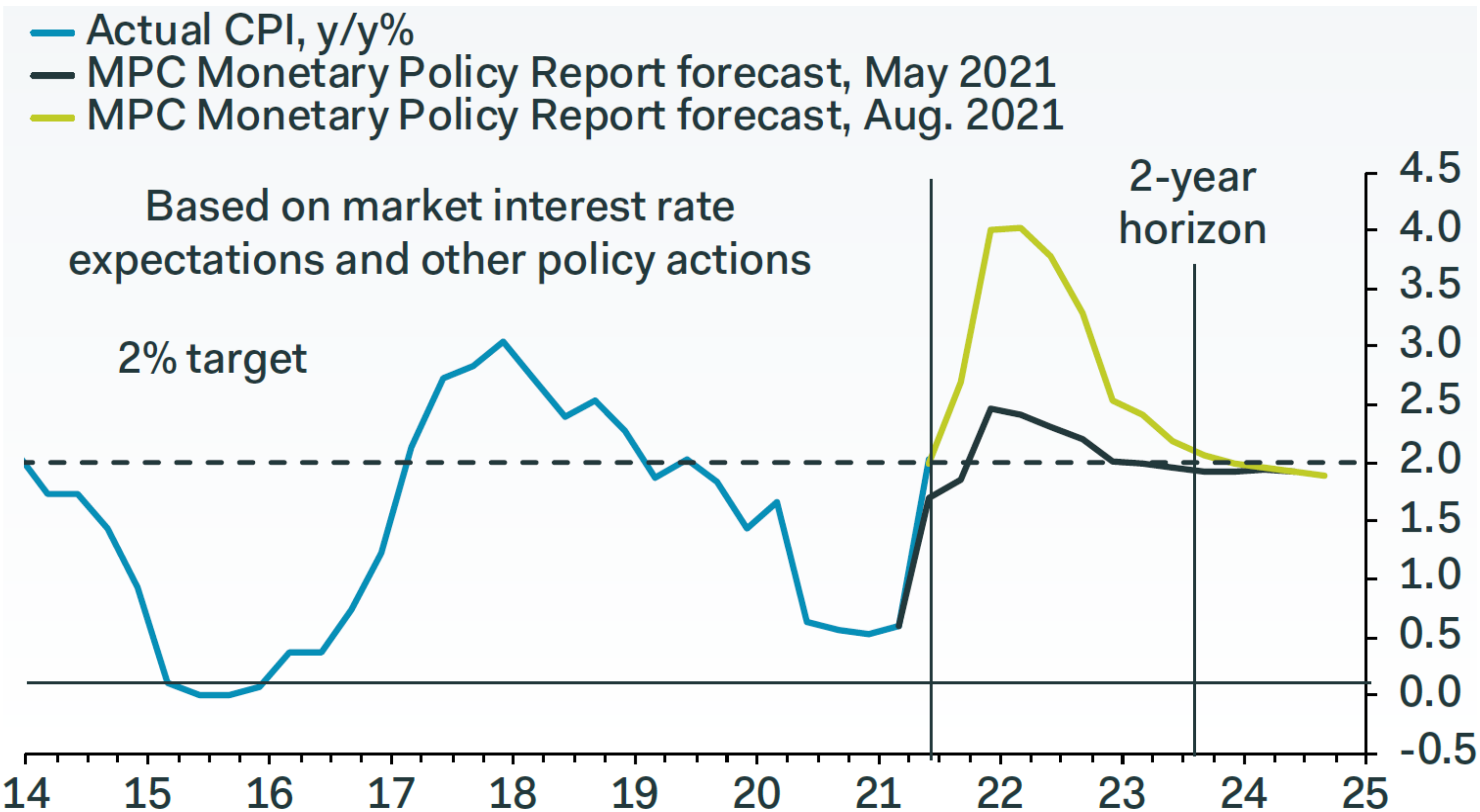
… and amongst businesses.



The UK picture is broadly similar, but the BoE's MPC, just like the Federal Reserve Bank in Washington, expect CPI to come back to 2% within two years.

UK Consumer Price Inflation (%)

Actual and Forecasts



The Eurozone, on the other hand, is facing far more modest inflationary pressures.

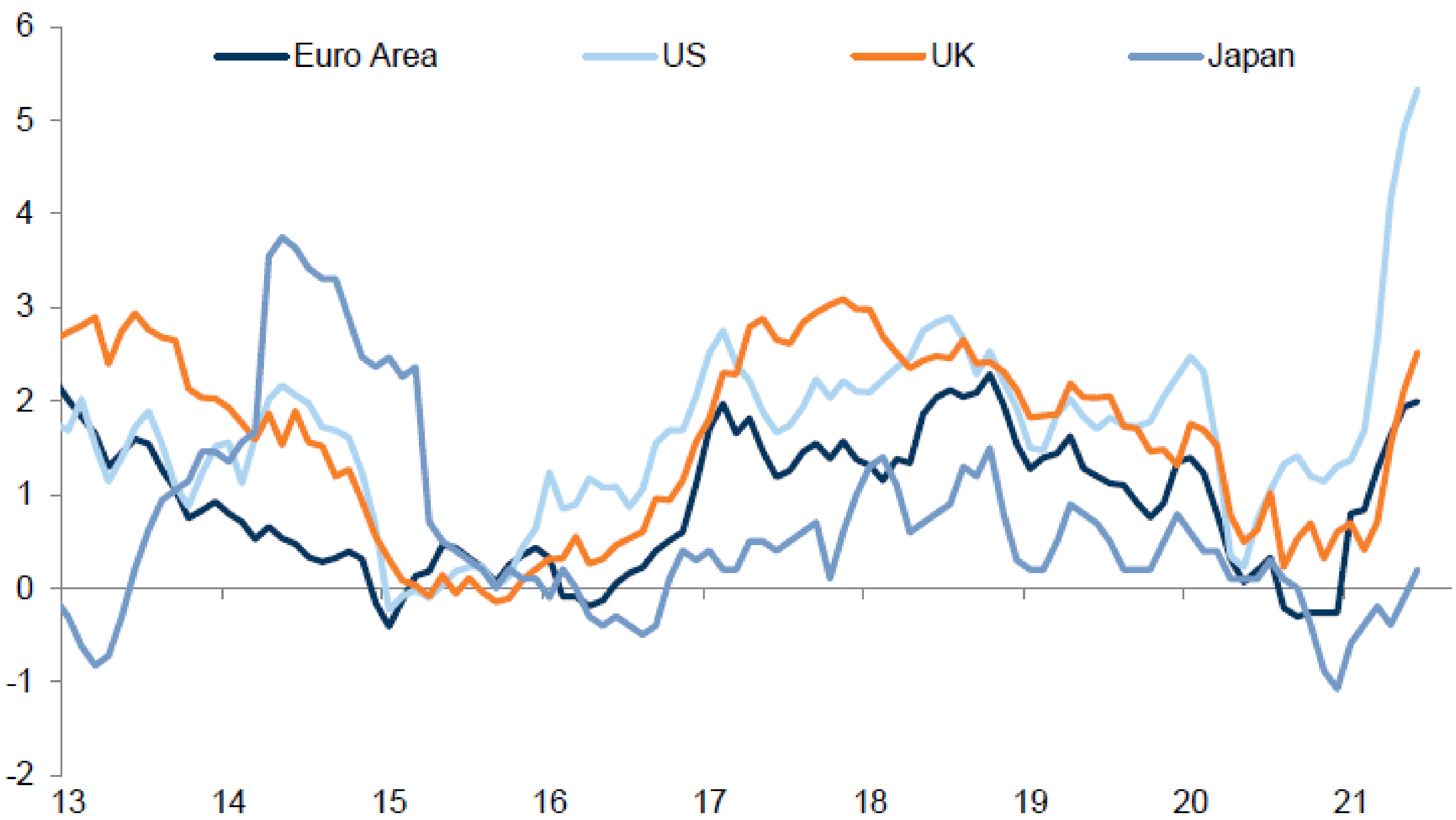
Inflation Pervasiveness Indices (%)

The UK vs. the Eurozone

Within the OECD, the US outlook is by far the most worrying.

Consumer Price Inflation, YoY (%)1

Various Countries



Part 2

HOW TO POSITION YOURSELF

… OUR TOP 6 RECOMMENDATIONS

The typical link between inflation and the key asset classes in the US:

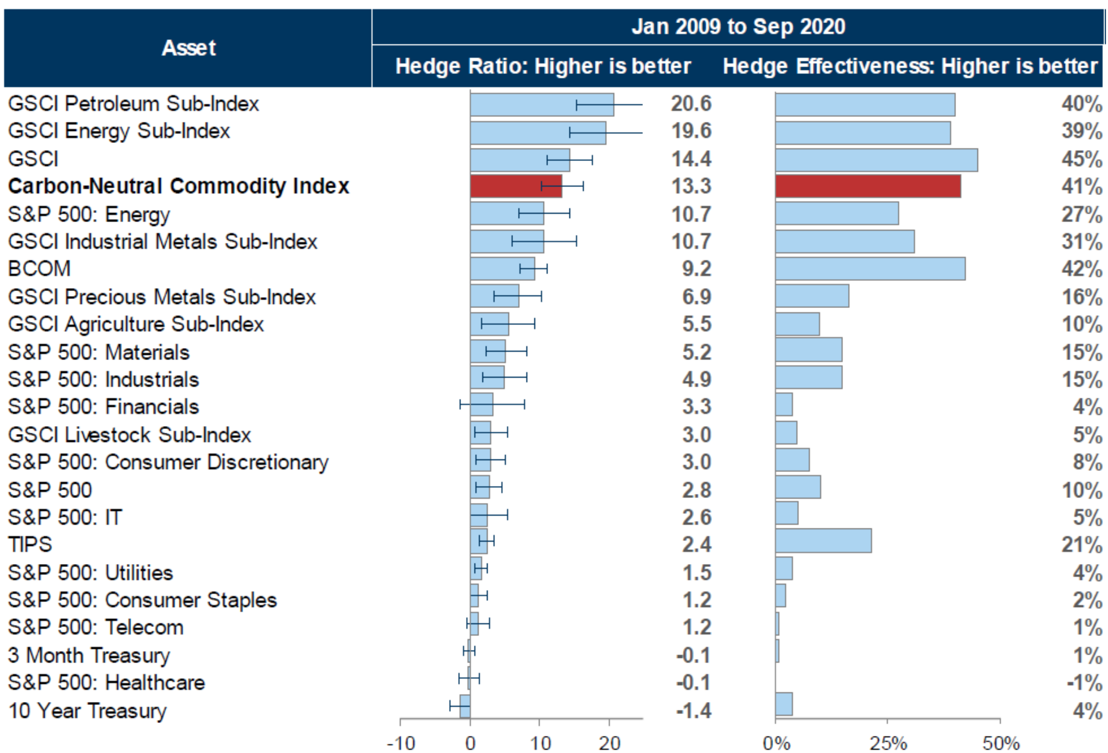
Inflation's Impact on the Main Assets Classes

1990-2020, US Data

	Asset class	Relationship	Index
Stocks	• U.S. large-cap stocks • Developed foreign stocks • Emerging market stocks	• Positive • Strong Negative • Strong Negative	• S&P 500 Index • MSCI EAFE GR USD • MSCI EM GR USD
Bonds	• Investment grade bonds • Treasury inflation-protected (TIPS)	• Strong Negative • Positive	• Bloomberg Barclays Aggregate Bond Index • Bloomberg Barclays Global Inflation-Linked: U.S. TIPS
Real assets	• Real estate stocks • Commodities	• Strong Positive • Strong Positive	• Dow Jones US Select REIT Total Return • S&P GSCI Commodity Index

#1: Do **not** invest in inflation-linked bonds, nor in gold, unless you think the outlook is even murkier than I think it is.

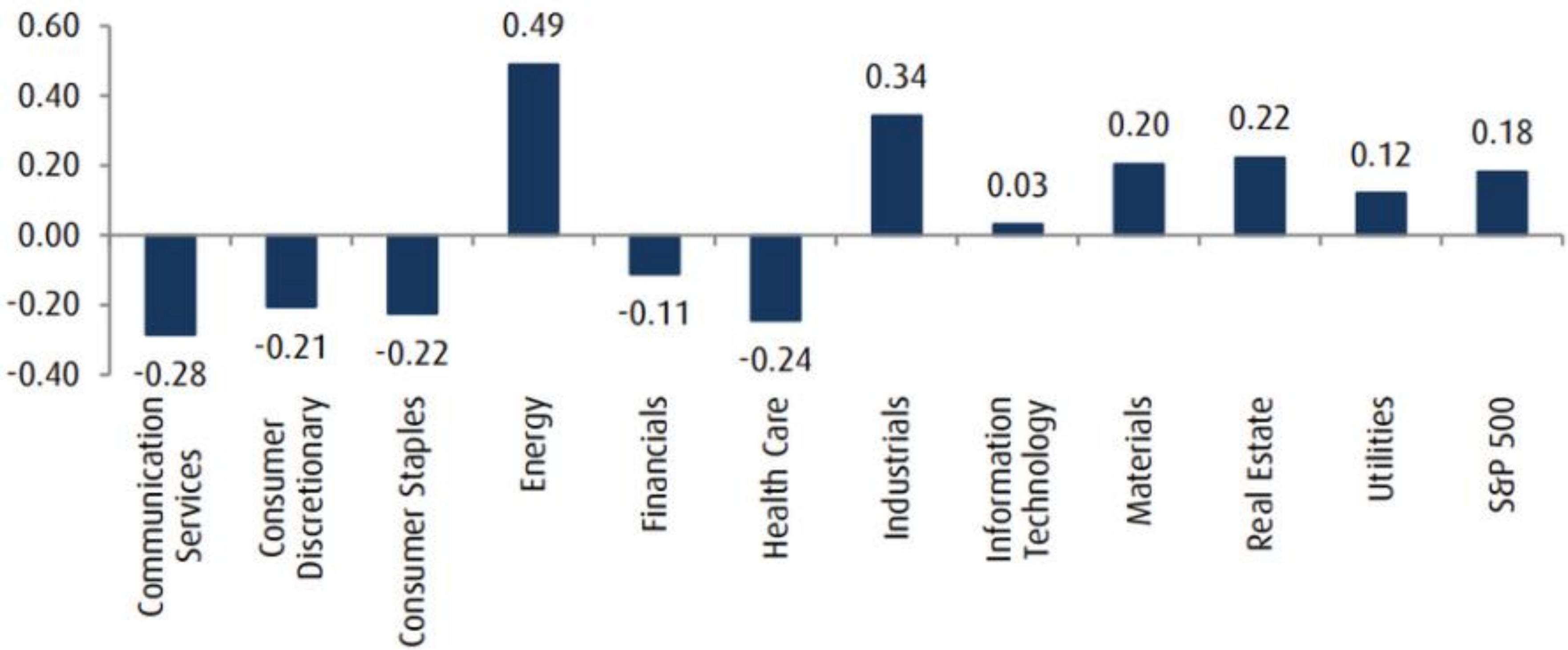
- Historically, both have offered far better protection against *un-anticipated* inflation than against a widely expected rise in inflation.
- I believe the current rise in inflation is well-advertised so wouldn't add to either at this point in time.



#2: Do **not** invest in energy. Despite it having a good track record as a hedge against inflation, the energy transition has made that call highly unpredictable.

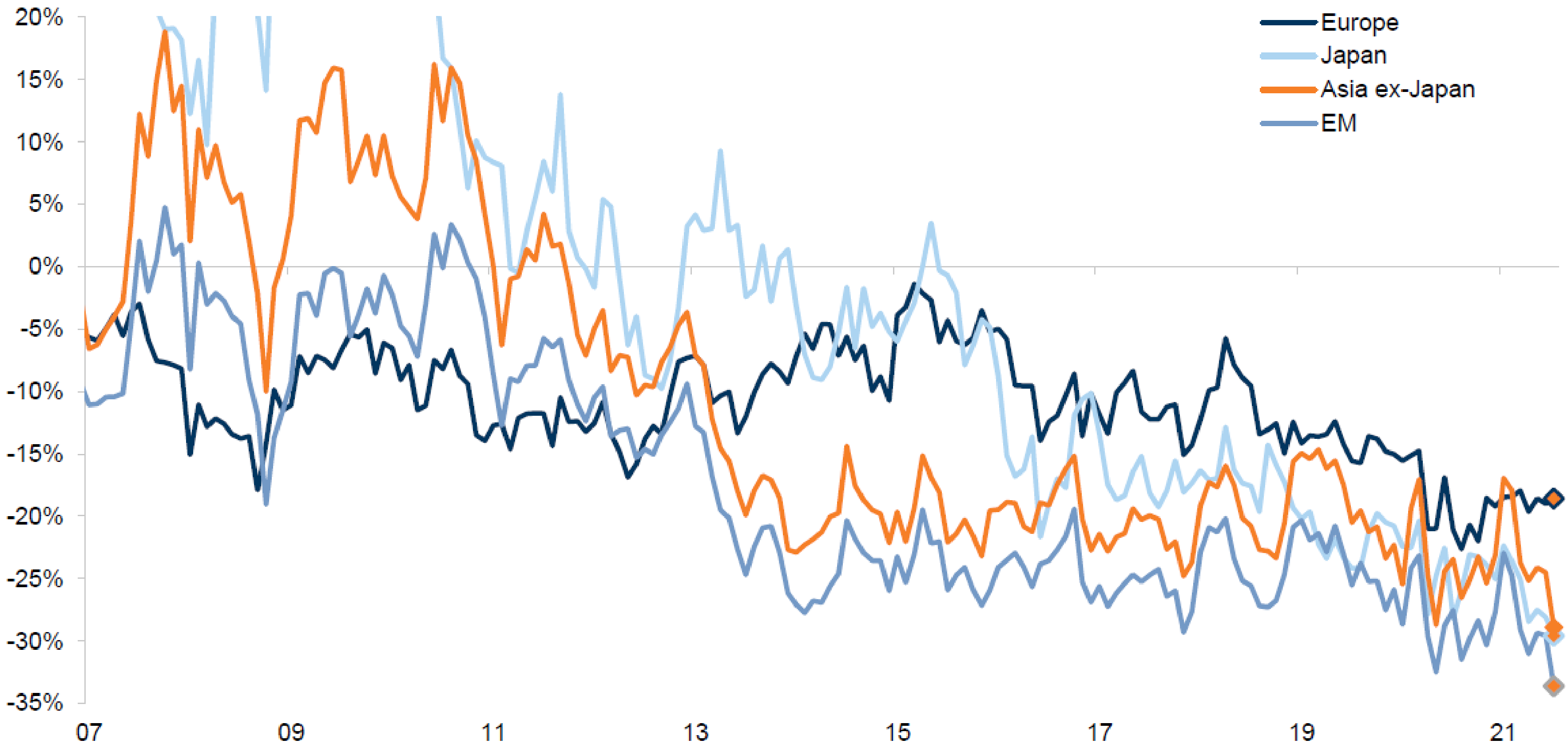
Correlation Between Relative Sector Returns & US PPI Minus US CPI

Monthly S&P data since 1990. All numbers are in % terms year-on-year



#3: Either reduce your (long) exposure to US equities (they have dramatically outperformed over the last ten years), or switch from growth to value.

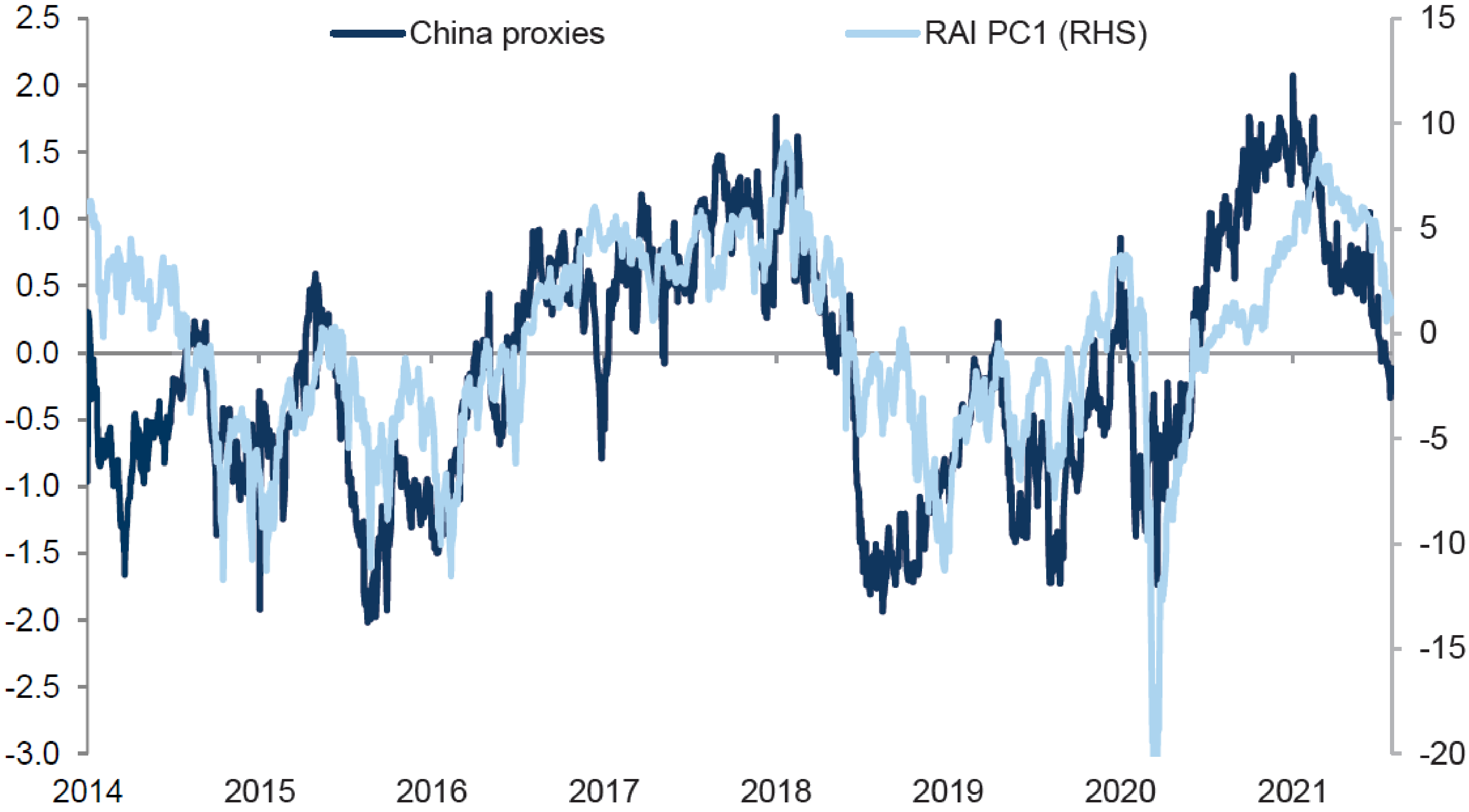
24m Sector-Adjusted P/E Premium/Discount vs. US Equities



#4: Reduce your (long) exposure to Chinese equities. Chinese fortunes are closely linked to global growth, and China will suffer if global growth slows.

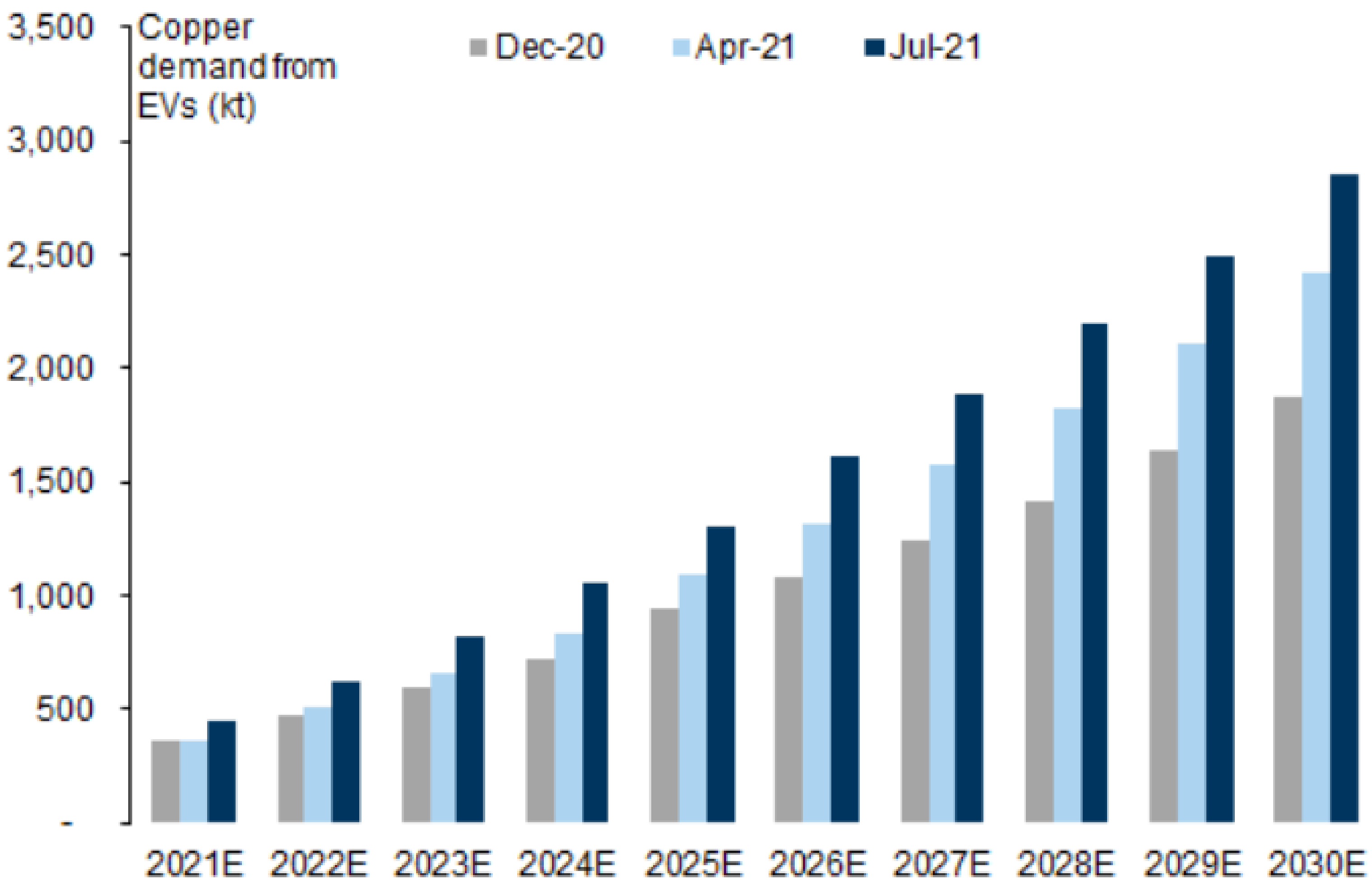
Global Growth vs. China Proxies

RAI PC1 vs. Average Z-Scores



#5: Increase your exposure to commodities, particularly to those commodities that benefit from the energy transition.

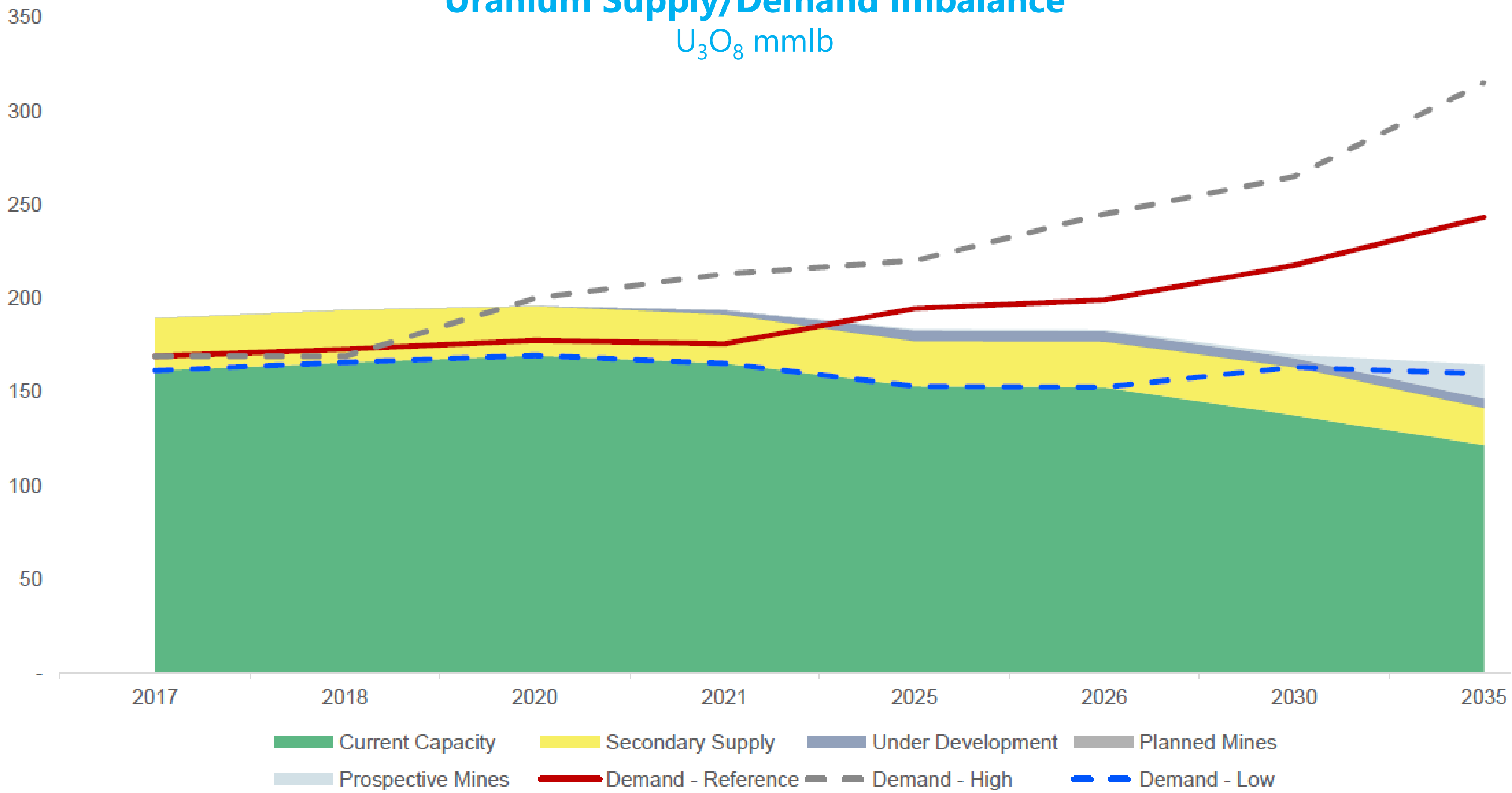
Green Demand for Copper



#6: Add uranium to your portfolio. Both demand and supplies are relatively predicable, and demand will exceed supplies for years to come.

Uranium Supply/Demand Imbalance

U_3O_8 mmlb



Part 3

CONCLUDING OBSERVATIONS

Concluding observations (1 of 2).

- My favourite inflation trade is, at least at present price levels, commodities. Within that space, my #1 pick is green metals, which would include copper, aluminium, nickel, lithium, graphite and silver.
- Although a somewhat controversial pick, I would add uranium to that list. We will never get the climate crisis under control unless fossil fuels are abandoned, and renewables *cannot* singlehandedly provide the energy the world needs. That leaves only one alternative – nuclear.
- My biggest AVOID is fossil fuel-based energy. Over the very long term (30 years+), fossil fuel prices will most likely go to $0 but, in the short to medium term, anything can happen. It is entirely unpredictable.
- Unless I underestimate the coming rise in inflation, equities should do relatively well, as long as you stay clear of companies with limited pricing power. Equities almost always do well when inflation is rising, unless inflation is out of control (as it was around 1980). Since 1962, US equity returns have annualised 8% in high-inflation regimes and 15% in low-inflation regimes, i.e. equities still deliver decent returns in high-inflation regimes.
- To be continued …

Concluding observations (2 of 2).

- … Continued.
- How do bonds fit in? That is a tricky question, and the answer depends on to which degree rising inflation undermines GDP growth. The more it does, the more accommodating you should expect central bank policy to be, and the better bonds will perform.

Appendix A

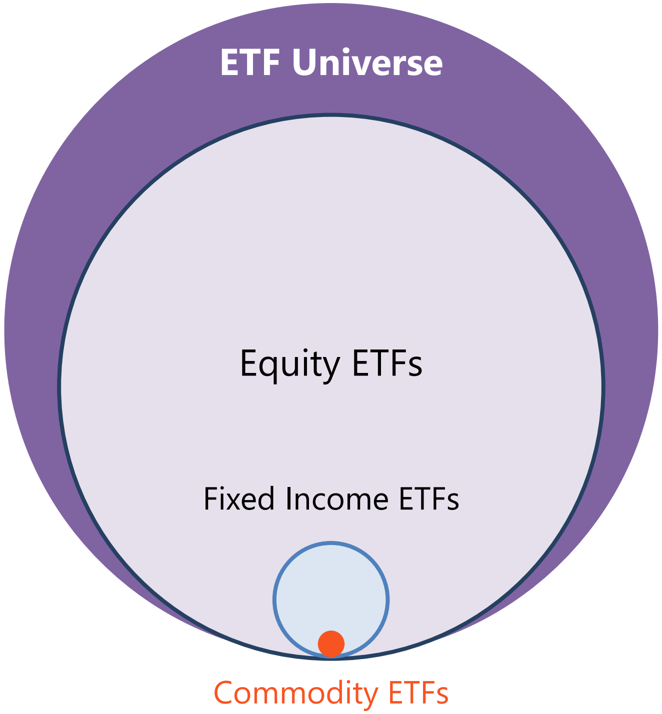
THE GRAYSWAN COMMODITY INDEX

…A SIMPLE WAY TO BE EXPOSED TO COMMODITIES ACROSS THE SPECTRUM

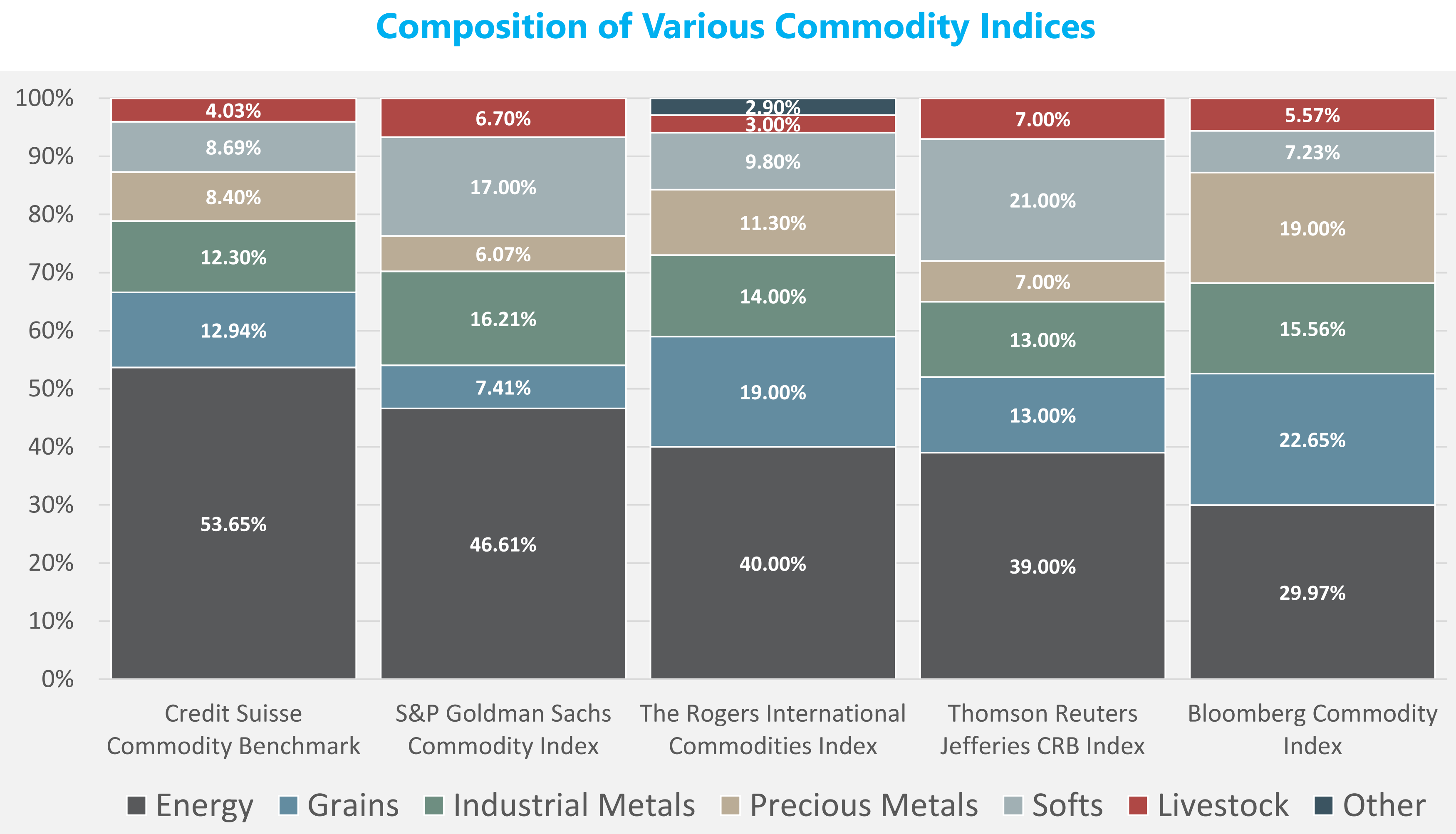
In the US, commodities account for only 2% of the ETF universe, and precious metal ETFs make up over 70% of all commodity ETFs.

The ETF Universe by Asset Class

Asset Class	# of ETFs	AUM million	%
Equity	**1772**	**4,941,789.20**	**79.10%**
Fixed Income	455	1,144,017.97	18.31%
Commodities	99	136,326.06	2.18%
Asset Allocation	85	15,613.85	0.25%
Alternatives	48	7,866.43	0.13%
Currency	17	1,858.71	0.03%
Total	**2476**	**6,247,472.22**	**100.00%**

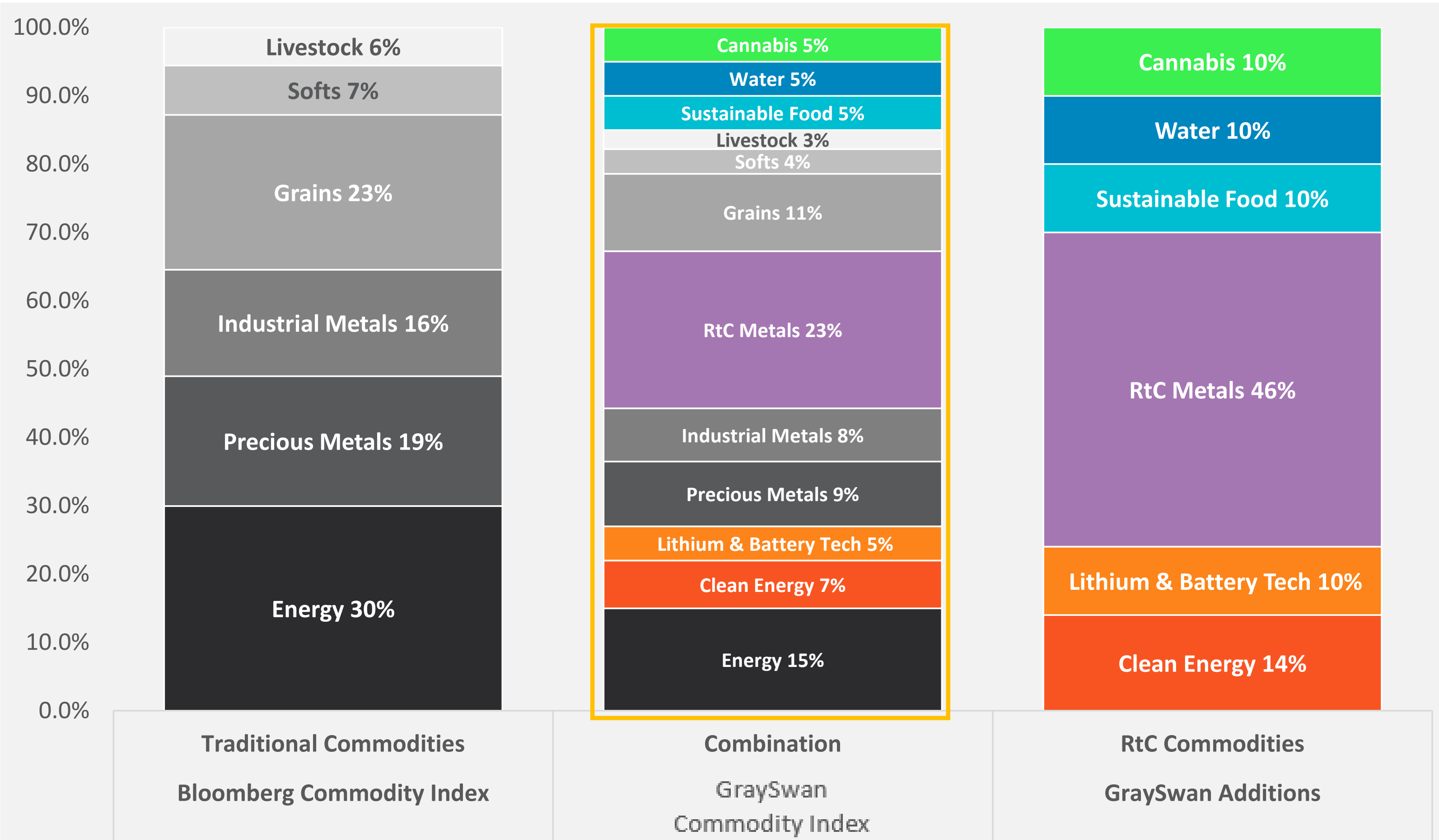


Almost all commodity indices are heavily exposed to energy, and almost none of them have a meaningful exposure to tomorrow's commodities.



GraySwan has solved this problem by establishing a new index, consisting of 50% BCOM and 50% commodities of the future.

Sector Breakdown of GraySwan's Commodity Index



You can invest in the GraySwan Commodity Index through two different online platforms.

Contact GraySwan at info@grayswan.co.za where an advisor will assist you with setting up a discretionary mandate and opening an account with either one of the below illustrated platforms.

Appendix B

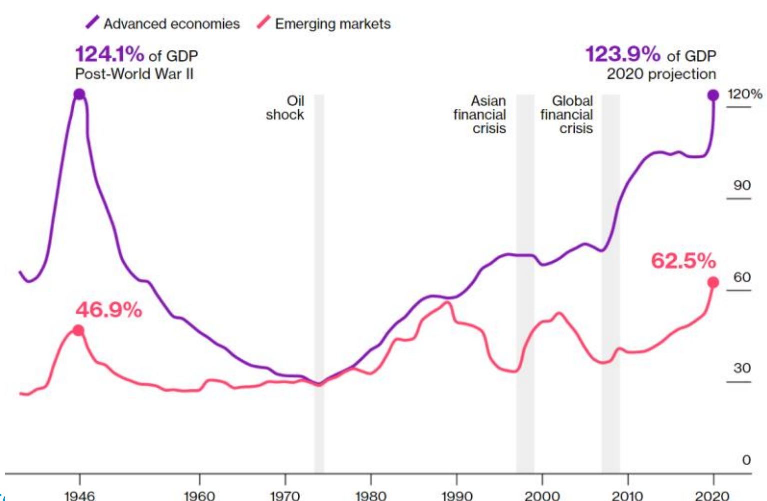
THE SIX MEGATRENDS

Megatrend #1

Last Stages of the Debt Supercycle

- In the early stages of a typical debt supercycle, GDP and debt grows 1:1, but that ratio deteriorates as the cycle matures. All prior debt supercycles have come to an end when GDP grows only $0.20-0.25 for every dollar of added debt. China is now at 0.21 and the US at 0.28.
- The fact that ΔProductivity and ΔGDP are both struggling to gain momentum at present are powerful indications that we are fast approaching the end of the current debt supercycle.
- The pandemic has driven global government indebtedness to the highs of the previous supercycle and has moved the end of this supercycle closer.

Total Govt. Debt:
(% of GDP)

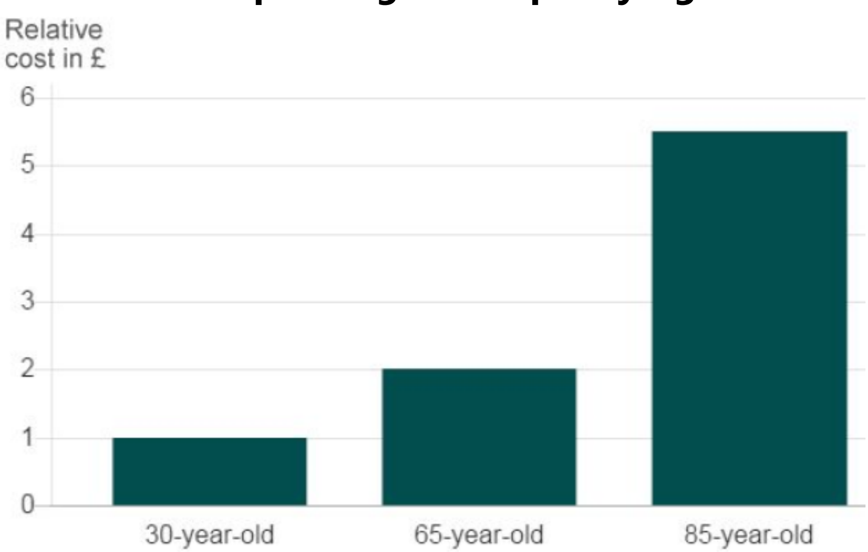


Megatrend #2

Changing Demographics

- 150 million OECD workers will retire between now and 2050.
- Servicing the elderly is extremely costly. According to the NHS, servicing a man in his mid-80s is 5-6 times more expensive than servicing a man at the age of 30.

NHS Spending on People by Age

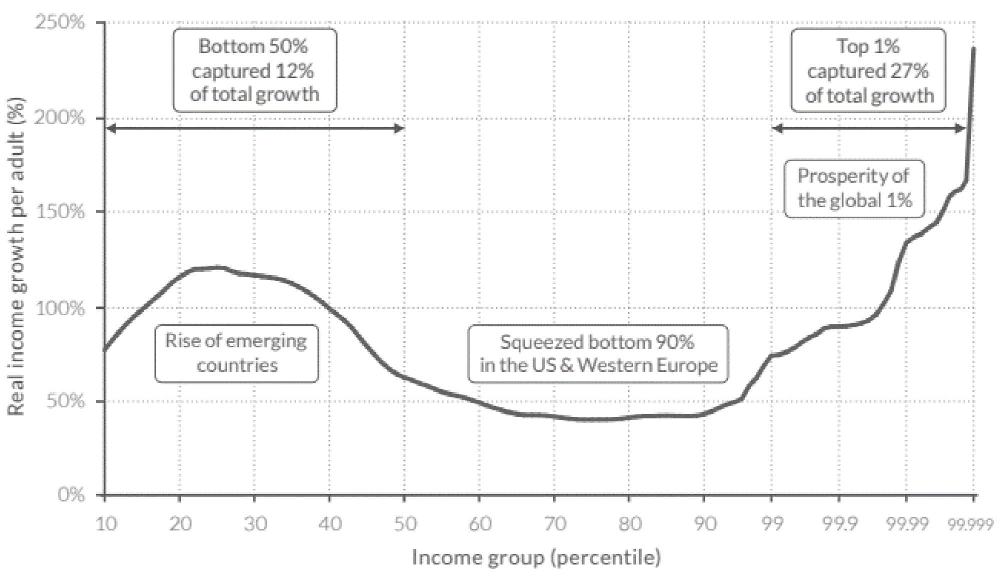


Megatrend #3

The Rising Gap between Rich and Poor

- Workers in many countries have not experienced any meaningful growth in real wages for years.
- Low or no real wage growth negatively affects aggregate demand and partly explains why GDP growth is so low everywhere.

Global Inequality



Megatrend #4

Rise of the East

- In PPP terms, China has more middle class families now than the US.
- The first thing people spend more money on when living standards improve is more and better quality food – almost always more protein-rich food.
- One should seek exposure to the phenomenal growth in the Chinese economy without being exposed to the over-leveraged financial system in China.

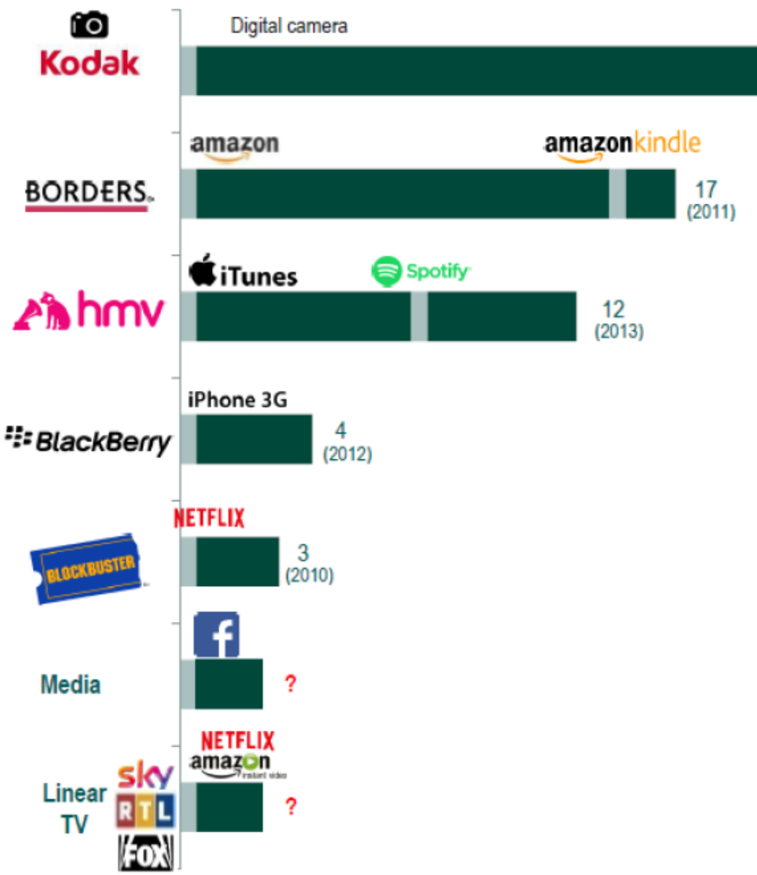
Chinese GDP Catch-Up under Various Assumptions

		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual US GDP Growth	1.00%	2047	2032	2027
	1.50%	2057	2034	2028
	2.50%	n/a	2041	2030

Megatrend #5

The Era of Disruption

No. of Years to Disrupt Incumbent's Businesses



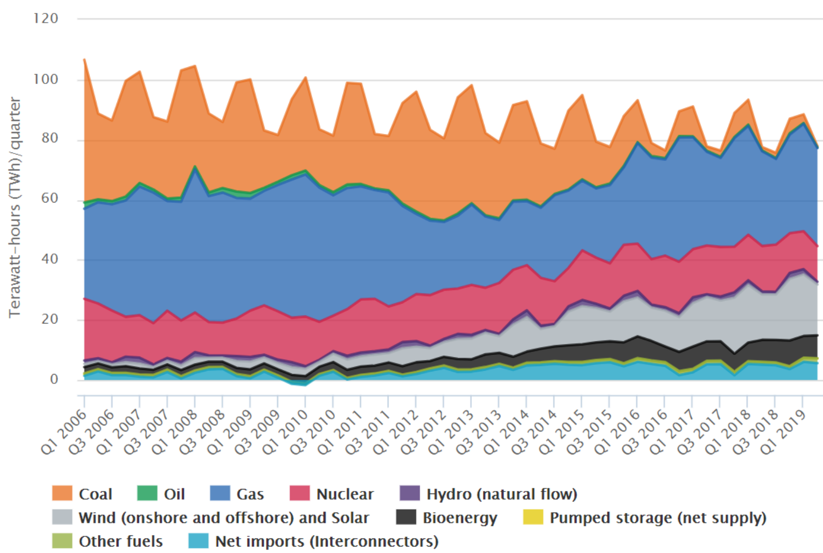
- Some disruptive businesses succeed whereas others don't; it is a misconception that entrants are disruptive by virtue of their success.
- Disruption is even more pronounced as a result of digitisation, but the disruption phenomenon is not at all limited to the technology industry.

Megatrend #6

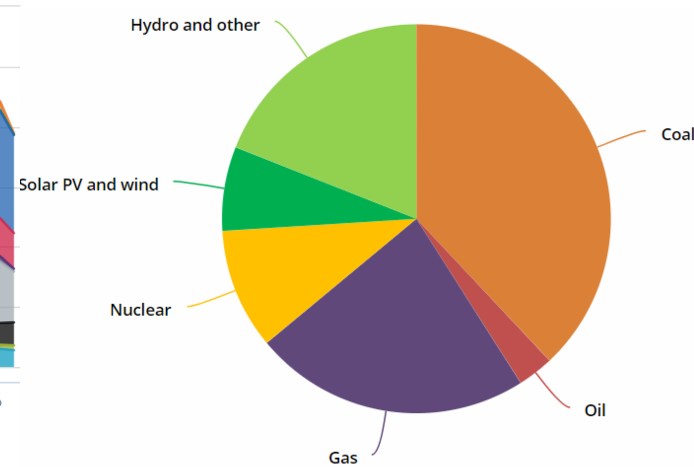
Climate Change

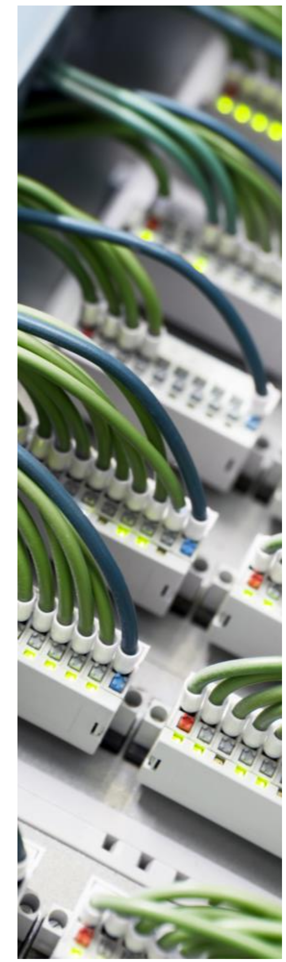
- The fight against global warming will drive governments all over the world to electrify most transportation and heating, dramatically reducing demand for fossil fuels.
- Food production must rise 60% in the next 20 years, and food production accounts for nearly 70% of all freshwater consumption globally. With climate change doing damage to our water supplies, how will this pan out?

UK Fuel Mix in Electricity Generation



Global Fuel Mix (2018)





... and the aggregate result of those six megatrends

Mean Reversion of Wealth-to-GDP

- Asset prices have grown much faster than GDP since the 1980s and, in the long run, one *cannot* outgrow the other.
- Every single time wealth has deviated meaningfully from its long-term mean value (380%), it has regressed to the mean, and US wealth is now (as of the 30th September 2020) almost 600% of US nominal GDP.

Total US Household Wealth-to-GDP since 1950

Important Disclosures

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