



The Inflation Tsunami

How will economic growth and financial markets be affected in 2022?

12th January 2022

Notes



In today's presentation, I will focus on the outlook for the US economy and US equities. I have chosen to zoom in on the US, as it is predominantly in the US you have this problematic combination of extraordinarily reflationary economic policies and uncomfortably high inflation.

Having said that, as we have all learnt over the years, when the economic superpower of the world is coughing, it doesn't take much for everybody else to catch the cold. In other words, just because the focus today is on the US, I am *not* suggesting you shouldn't worry about the impact elsewhere.

One additional point:

This presentation is based on the inflation statistics from November. The CPI numbers for December were published earlier this afternoon, too late to be included in this presentation.

Latest:

CPI climbed 7.0% in December as expected - the first time since February 1982 CPI is higher than 7%.

CPI ex. food & energy climbed 5.5% in December vs. expectations of +5.4%.

The PPI numbers for December will be released tomorrow.

Niels

12th January 2022

Agenda



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Part 1

THE VERY LATEST ON INFLATION

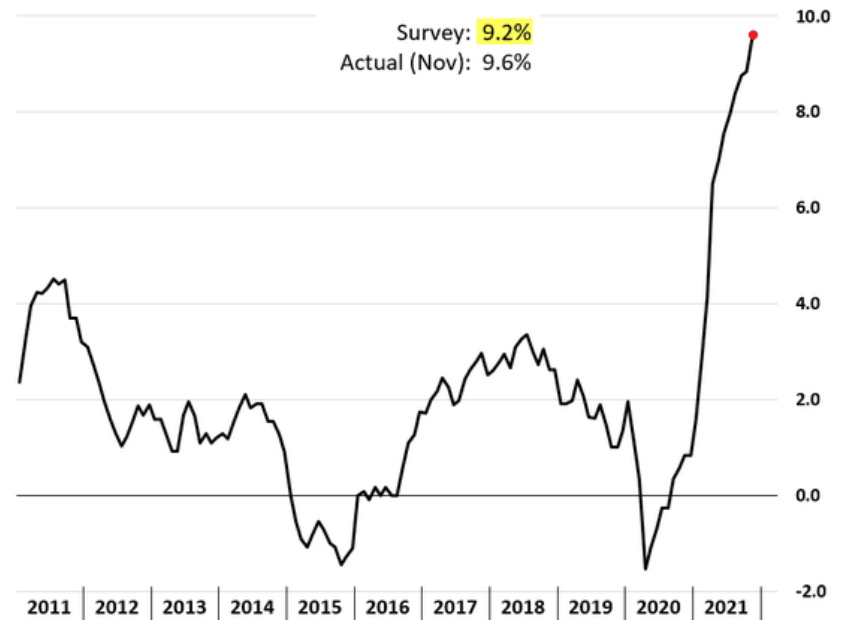


In the US, CPI and PPI continue to rise rapidly. As of the latest count, CPI is now running at 6.8% year-on-year and PPI at 9.6% year-on-year.

US CPI, Year-on-Year



US PPI, Year-on-Year



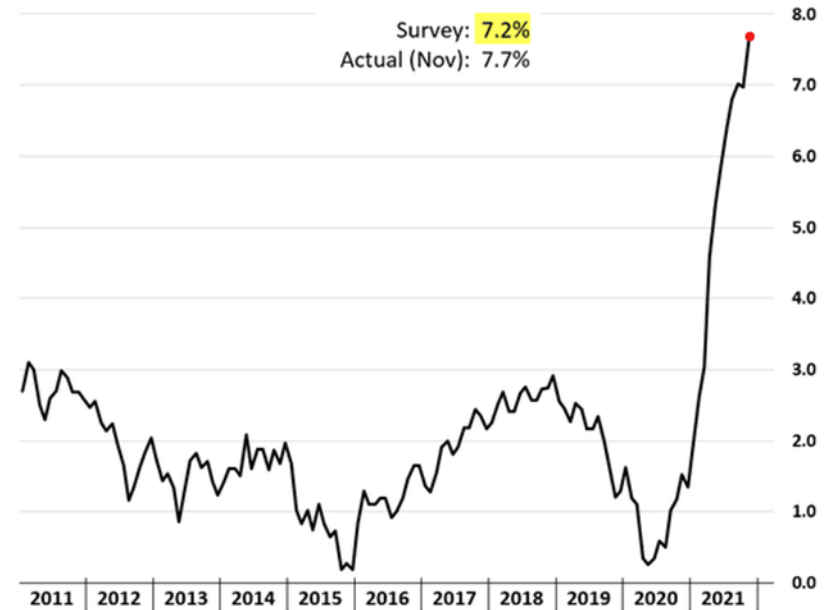
Latest: +7.0%

Rapidly rising energy prices are seen by many as the main culprit but, even when excluding energy, inflation is still running at uncomfortably high levels.

US Core CPI, Year-on-Year

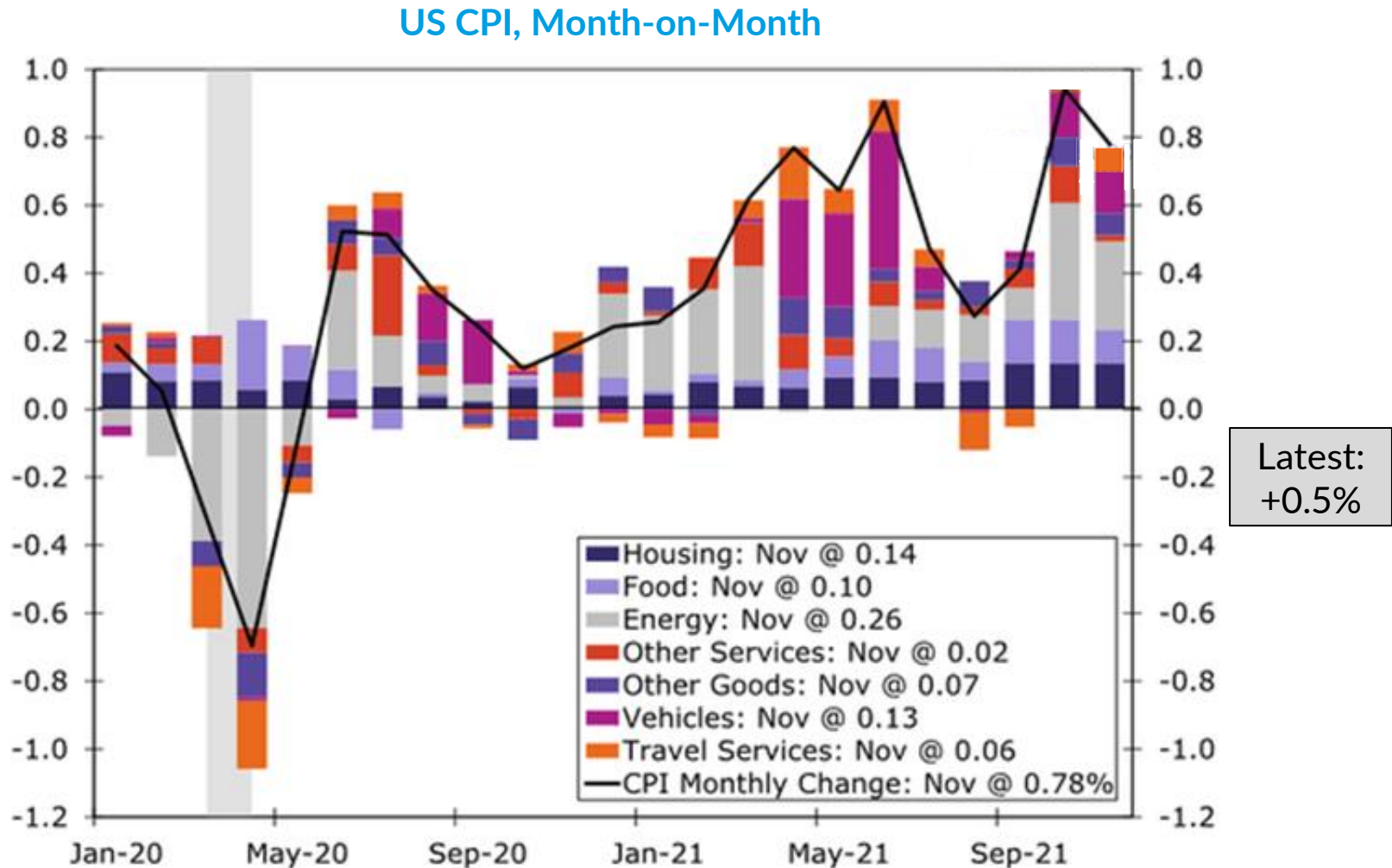


US Core PPI, Year-on-Year



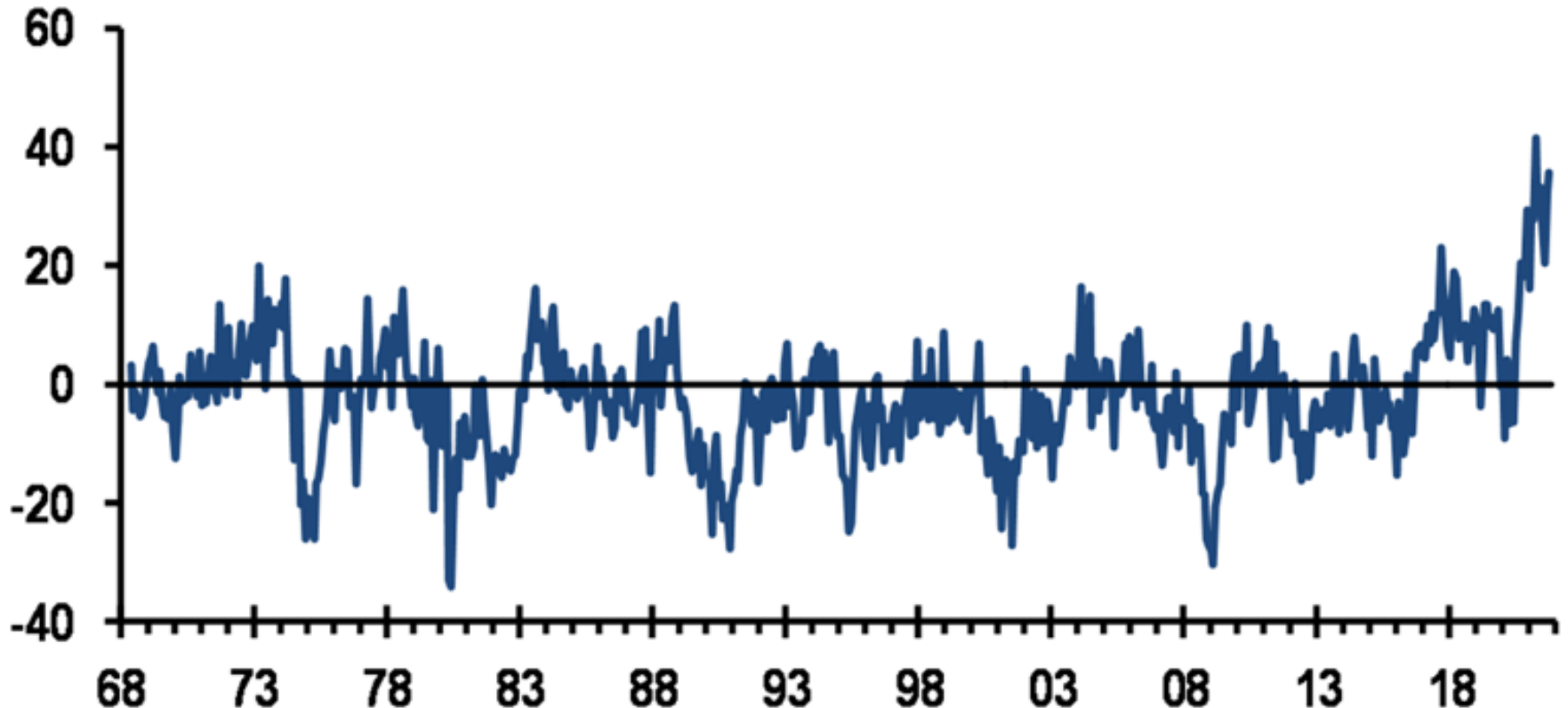
Latest: +5.5%

When the last CPI numbers were published, many took great comfort from the fact that CPI appears to have peaked when measured month over month.



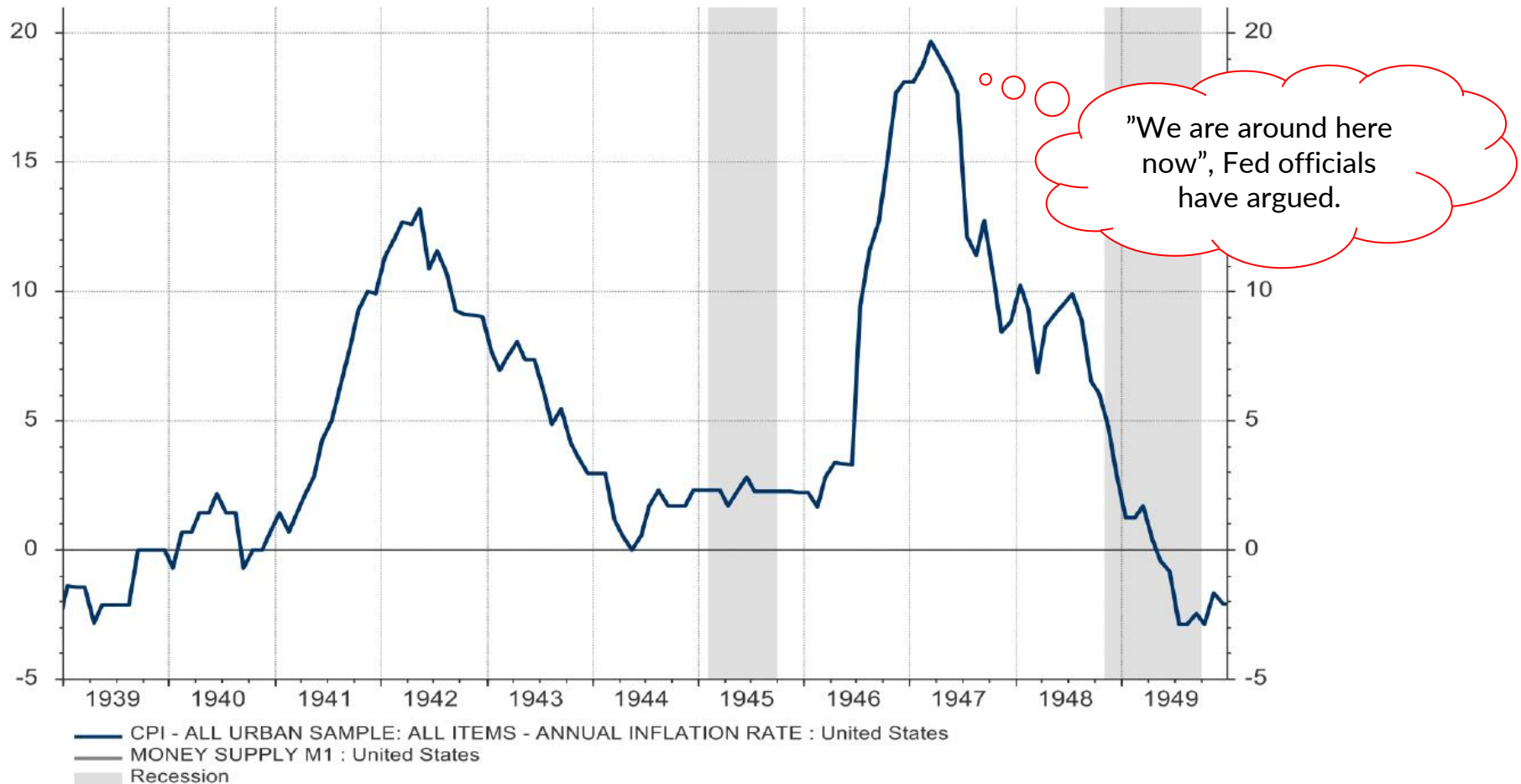
Fed officials maintain that the spike in inflation is mostly caused by bottlenecks in the supply chain, and that it is therefore transitory.

Philadelphia Fed Survey – Delivery Times



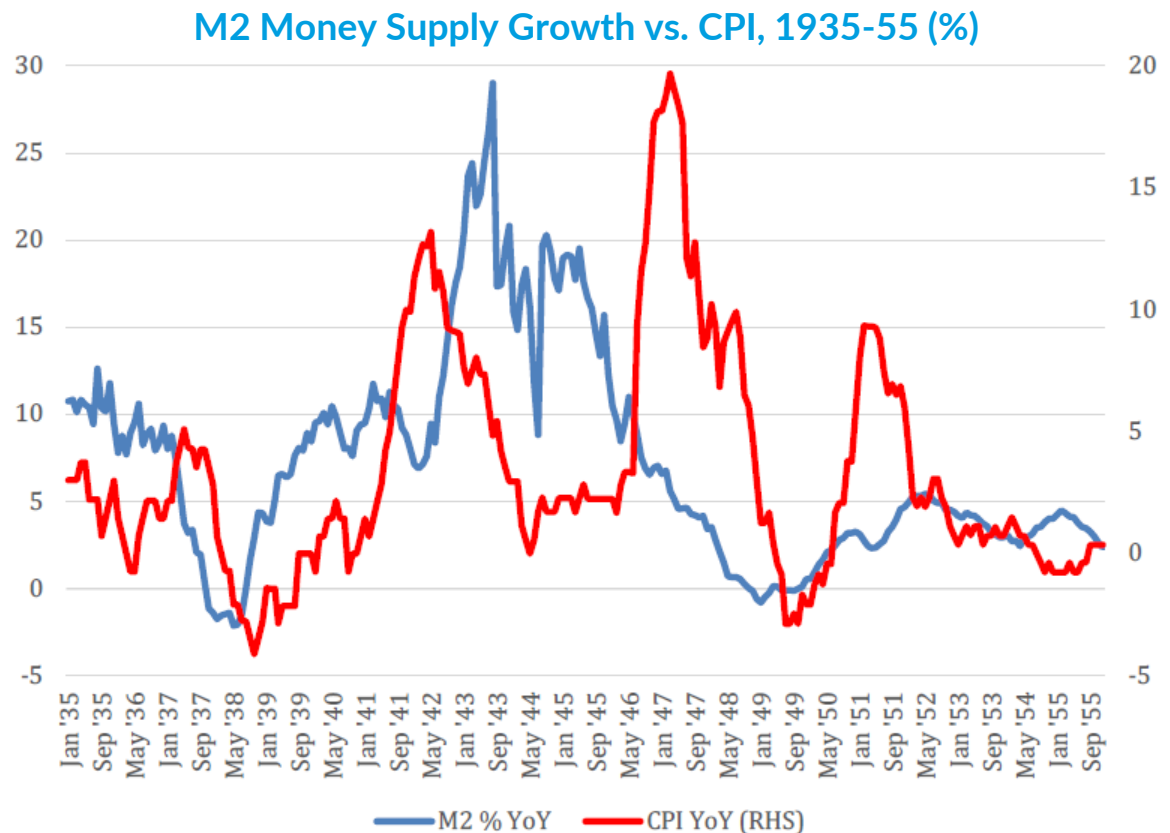
The argument has been that the current situation is very similar to the first few years after World War II – high personal savings, supply chain problems, etc.

US CPI, 1939-49

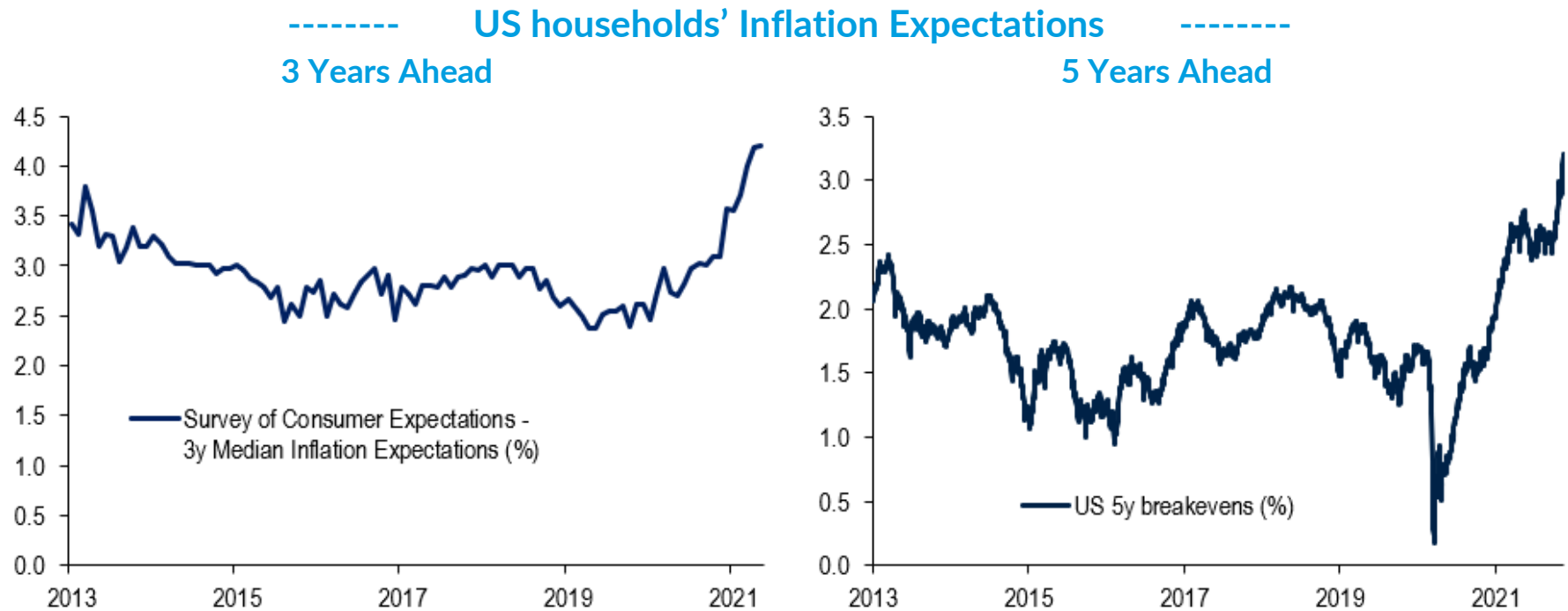


We believe the situation today is fundamentally different from the years during and after World War II.

- US price controls during WW II prevented normal pricing mechanisms from working. It is estimated that price controls during the war held the overall price level down by about 30%.
- Those controls were only lifted in the summer of 1946 and, as you can see below, the immediate impact on inflation was rather dramatic.
- In response, US money supply was tightened quite fiercely, unlike now where money supply is plentiful.



Households' inflation expectations have risen sharply more recently, which is likely to lead to higher wage demands in 2022.



Most worryingly, inflation expectations amongst US firms have also risen, which is likely to affect pricing of both goods and services in 2022.

US Firms' Inflation Expectations



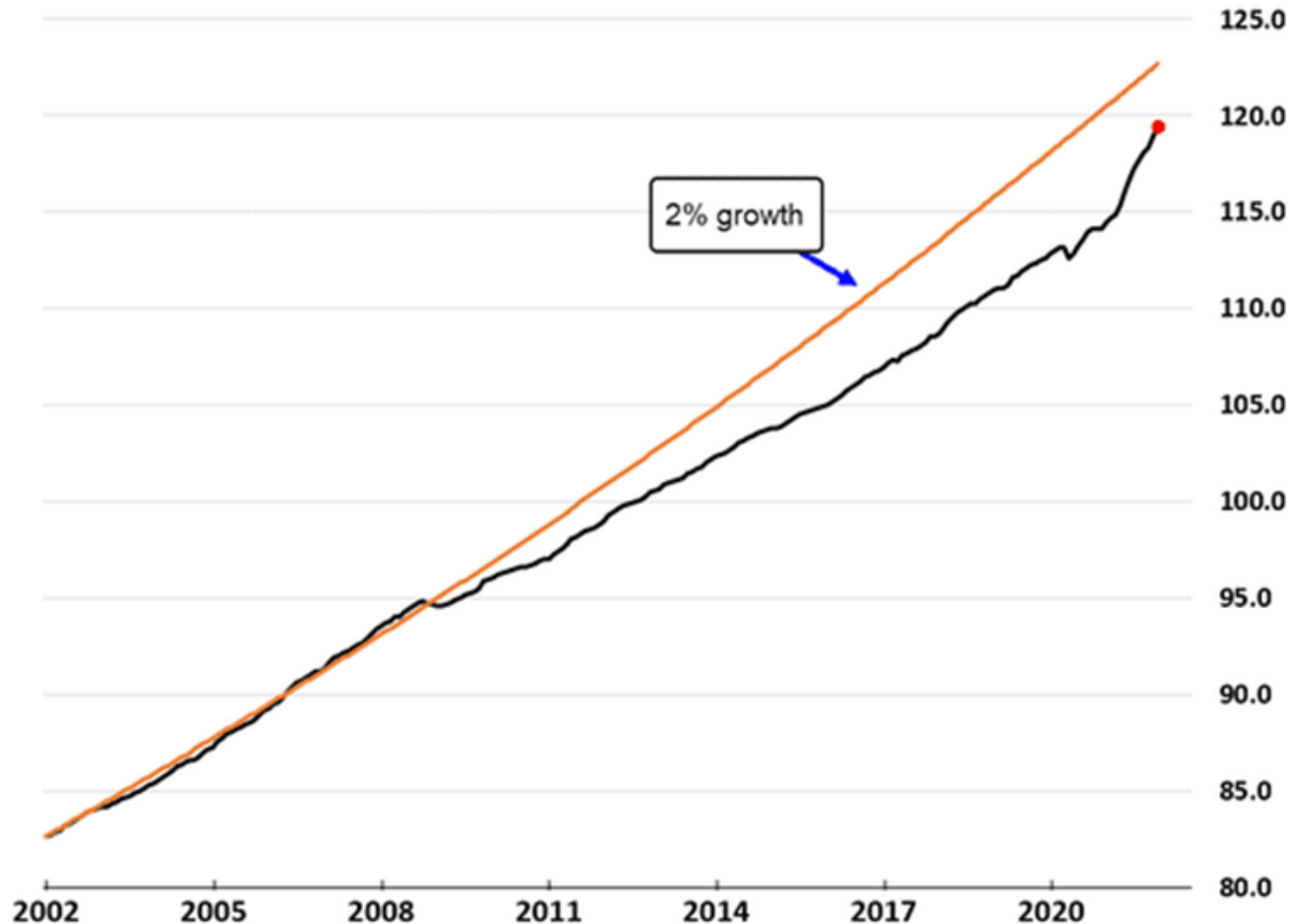
The Fed's preferred measure of consumer inflation, *core PCE inflation*, has also risen faster than expected in recent months. How will that affect the Fed's behaviour?

US Core PCE Inflation, YoY



Despite inflation rising rapidly more recently, the Fed is unlikely to react too dramatically unless (until) the 2% trendline has been broken.

US Core PCE Inflation, 2012=100



Are Fed officials finally caving in? It begins to look like it ...

Key observations from the December FOMC meeting:

- The FF target rate will be left unchanged for now at 0-0.25%.
- The pace of tapering will be doubled to \$30Bn from January 2022.
- The FOMC noted that job gains have been "solid" in recent months, and that the unemployment rate has "declined substantially".
- Ten FOMC members (out of twelve) projected three hikes in 2022, up from zero in September. The remaining two members projected no less than four hikes in 2022.

My conclusions:

1. All FOMC members now project at least three hikes in 2022 – clearly a hawkish development.
2. The word "transitory" was dropped from the official FOMC statement. The new wording is that inflation "has exceeded 2% for some time" – another hawkish development.
3. The FOMC is, in my opinion, preparing to go to battle with inflation.

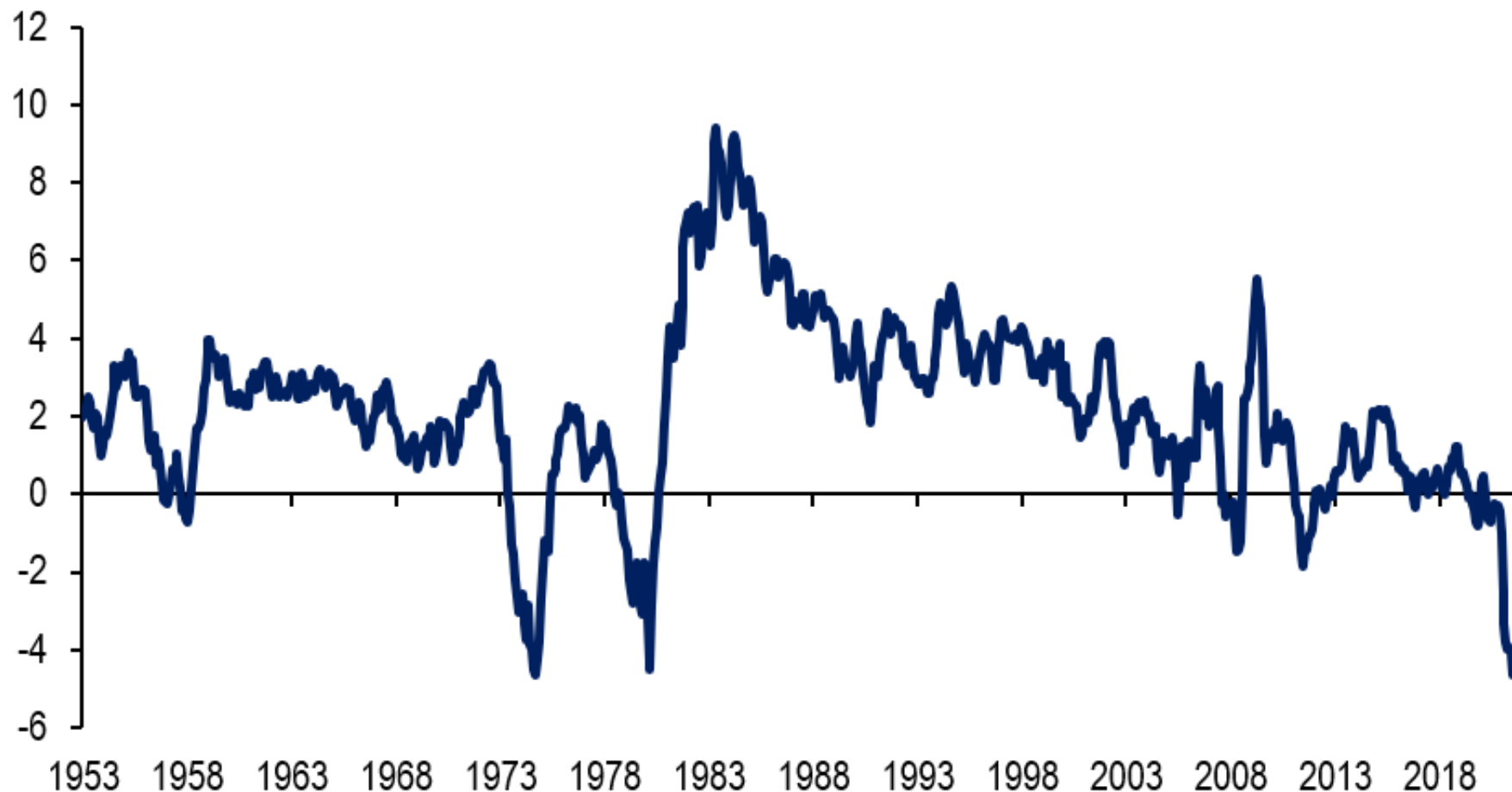
Part 2

ECONOMIC IMPLICATIONS



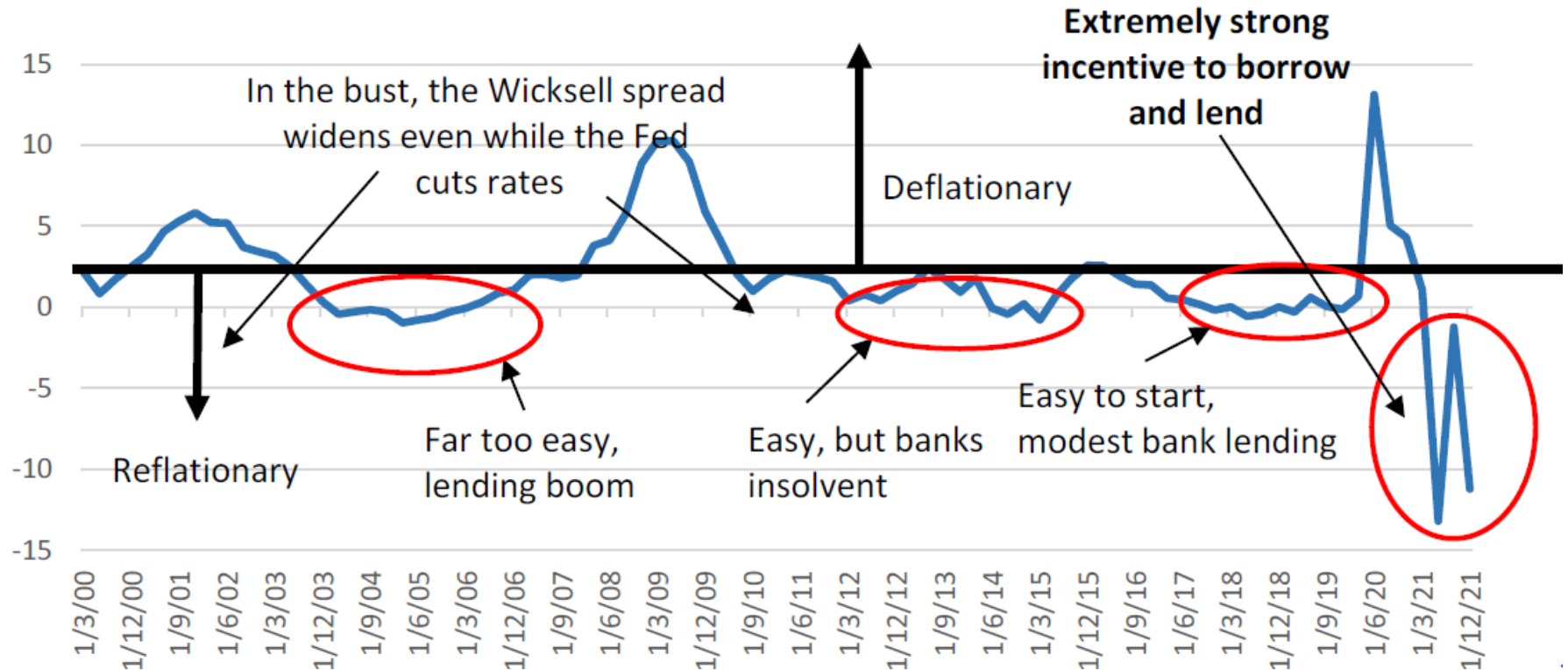
Is it part of the Fed's plan to inflate debt away? Real rates have not been this low for more than 70 years.

US 10-Year Treasury Yield Minus Annual Headline CPI



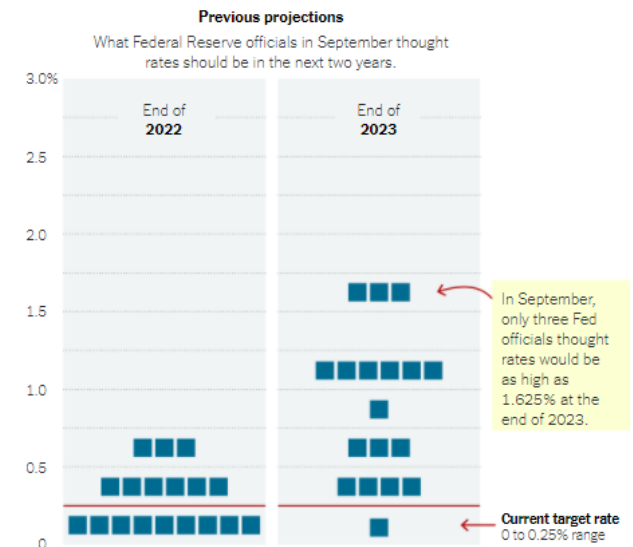
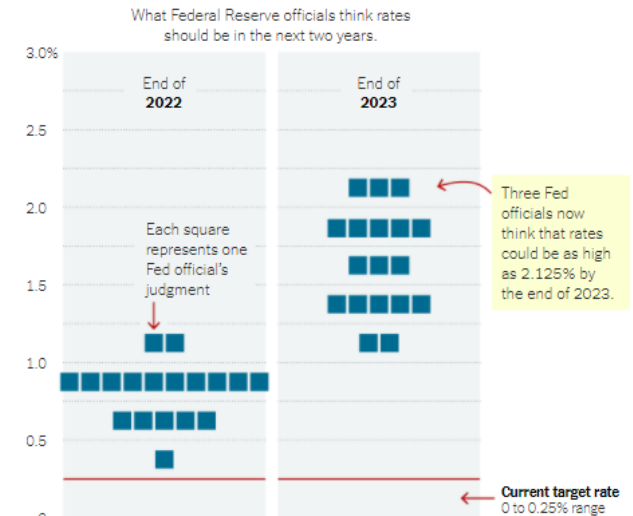
An extraordinarily low US Wicksell spread has created a strong incentive to borrow, which is highly reflationary, and that will support economic growth in the short term.

The US Wicksell Spread



To assess the implications for economic growth, the critical question is how fast the FOMC is going to act, following the hawkish turn in its last FOMC meeting.

- The probability of a hard landing is proportional to the speed and aggressiveness of the hiking to come. On the right, you can see the latest FOMC projections vs. the prior ones with each dot representing a member of the FOMC.
- Given how much more hawkish the Fed has turned, the probability of a hard landing has risen.
- This probability is rising further as a result of the highly negative Wicksell spread. Because of that, GDP growth will probably be respectable for much of 2022, potentially driving the FOMC to over-react, thereby causing a hard landing.
- Many households have taken advantage of extraordinarily low mortgage rates in recent years and locked in the rate for many years to come. This could present another problem for the FOMC, as private consumption may not react as quickly to a rate hike as it used to.
- We believe the probability of a hard landing is over 50%, i.e. it is now our base case scenario for the next 18 months.

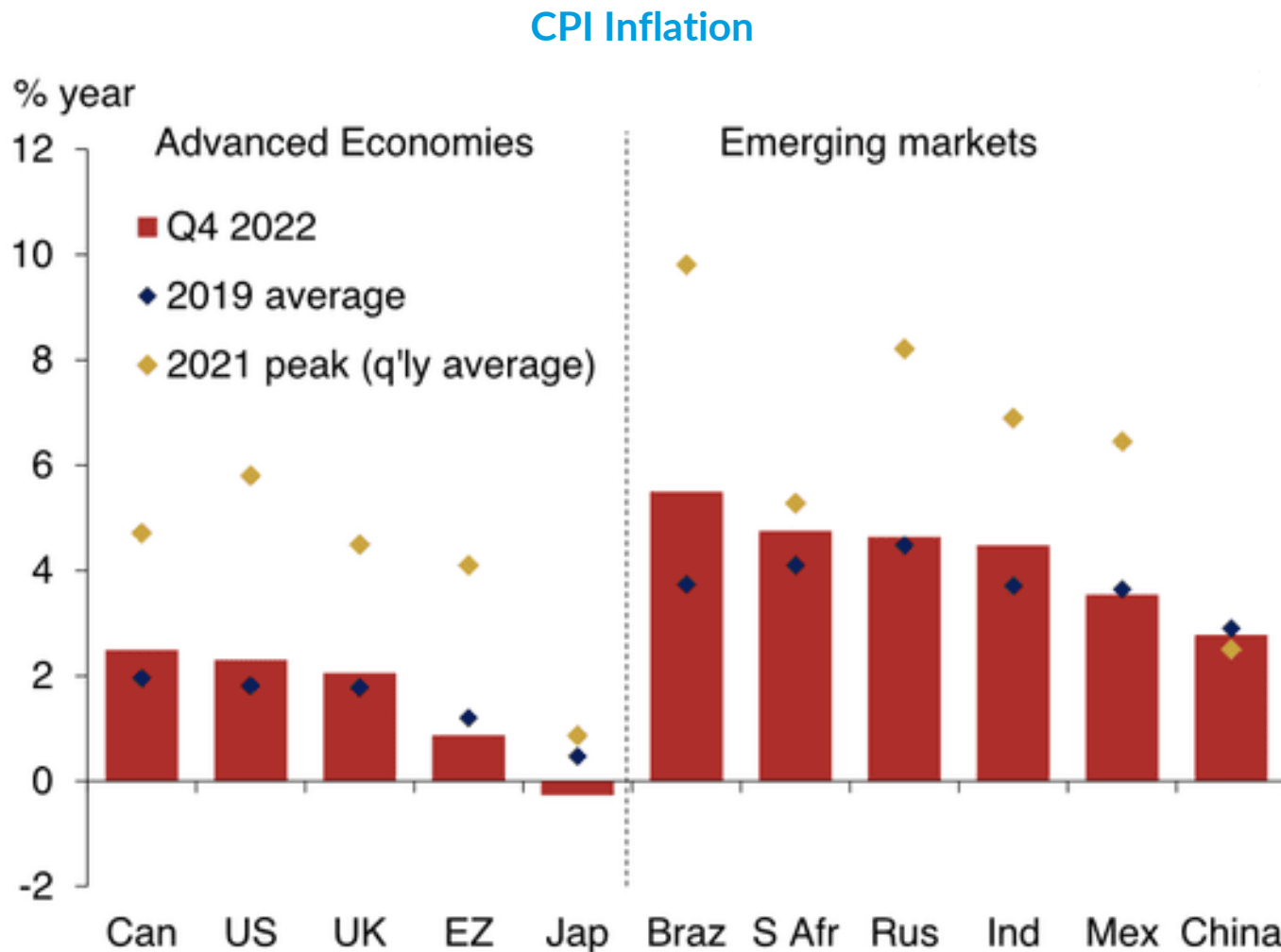


Part 3

FINANCIAL MARKET IMPLICATIONS AND OUR TOP RECOMMENDATIONS



Many leading research houses tend to agree with the Fed. Should inflation turn out to be stickier (as we think), both bonds and equities will probably take a hit.



How is a more hawkish stance from the Fed likely to affect various asset classes?

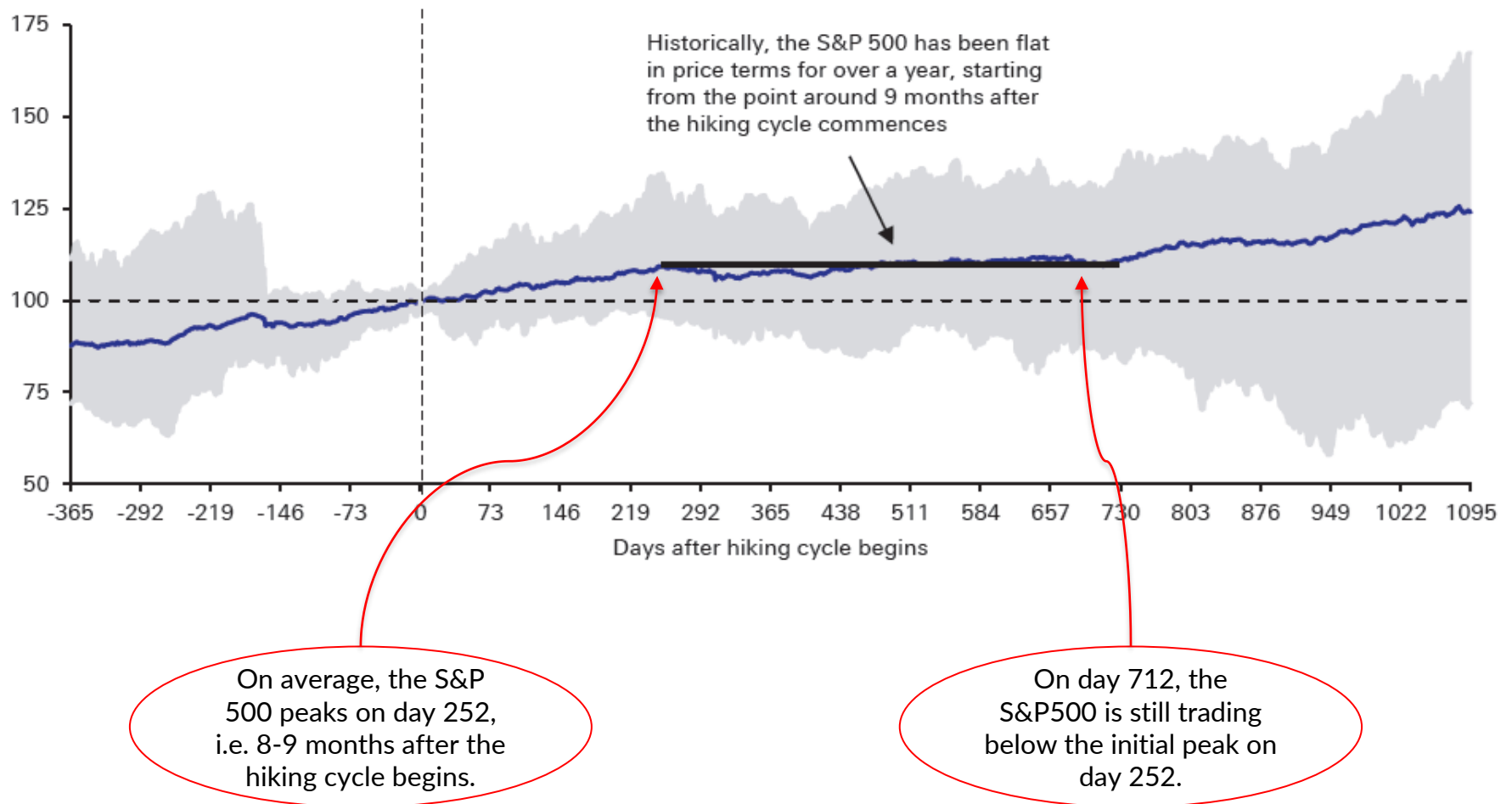
Expected Impact on Various Asset Classes

Asset Class	Soft Landing	Hard Landing
Equities	Neutral to Positive Impact	Very Negative Impact
Fixed Income	Depends on Inv. Grade	Depends on Inv. Grade
Yield Curve	Bull Steepening	Bear Flattening
Industrial Commodities	No Major Impact	Very Negative Impact
Soft Commodities (Agro etc.)	No Major Impact	No Major Impact
Precious Metals	Modest Negative Impact	Very Negative Impact

Given we now think the probability of a hard landing is over 50%, at least in the US, we recommend a rather defensive approach to asset allocation.

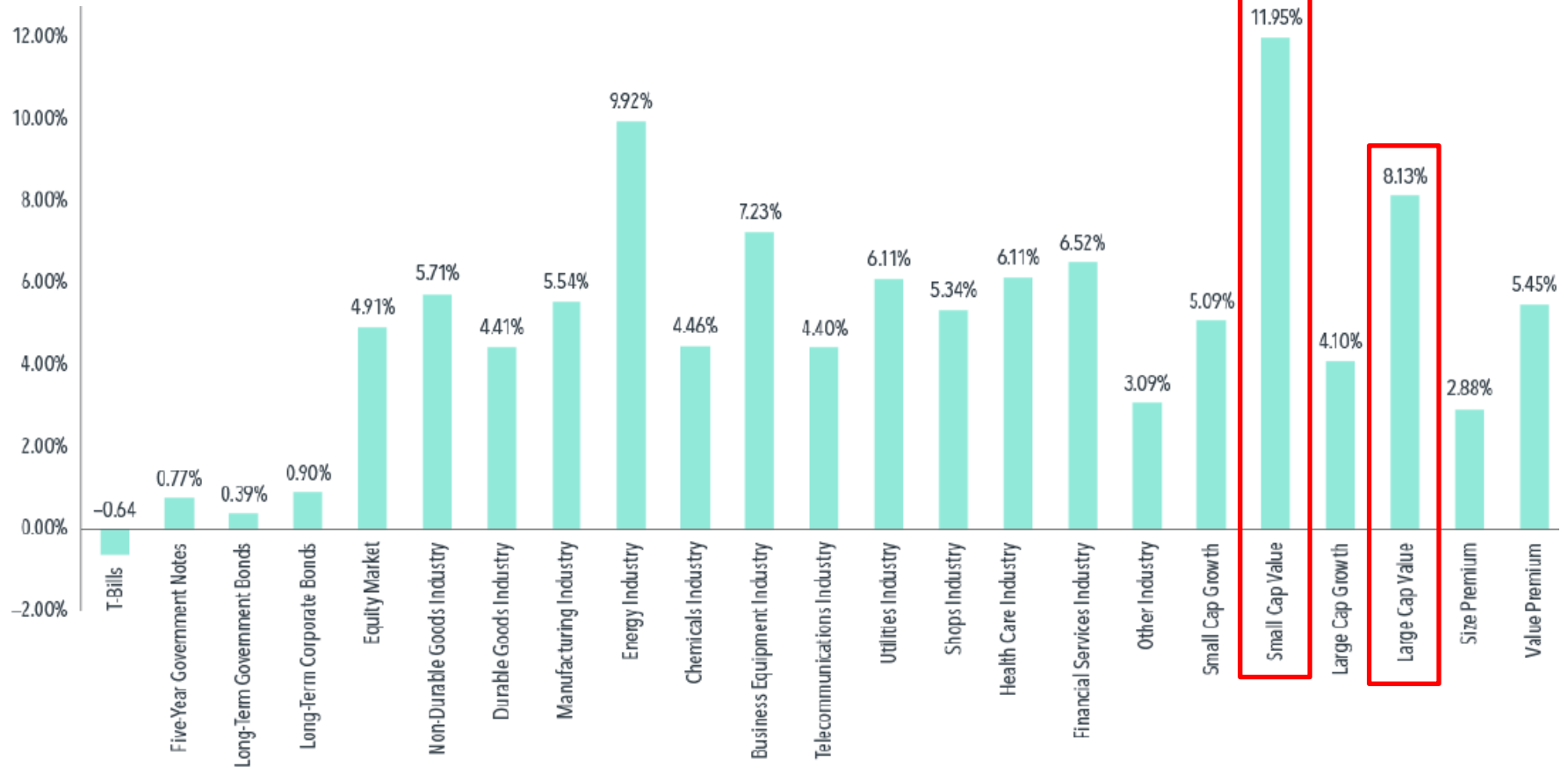
#1: We recommend you reduce your overall equity exposure and particularly your exposure to high equity beta stocks, as we go into hiking cycle #14 since 1955.

Average Performance of S&P 500 in Fed Hiking Cycles since 1955

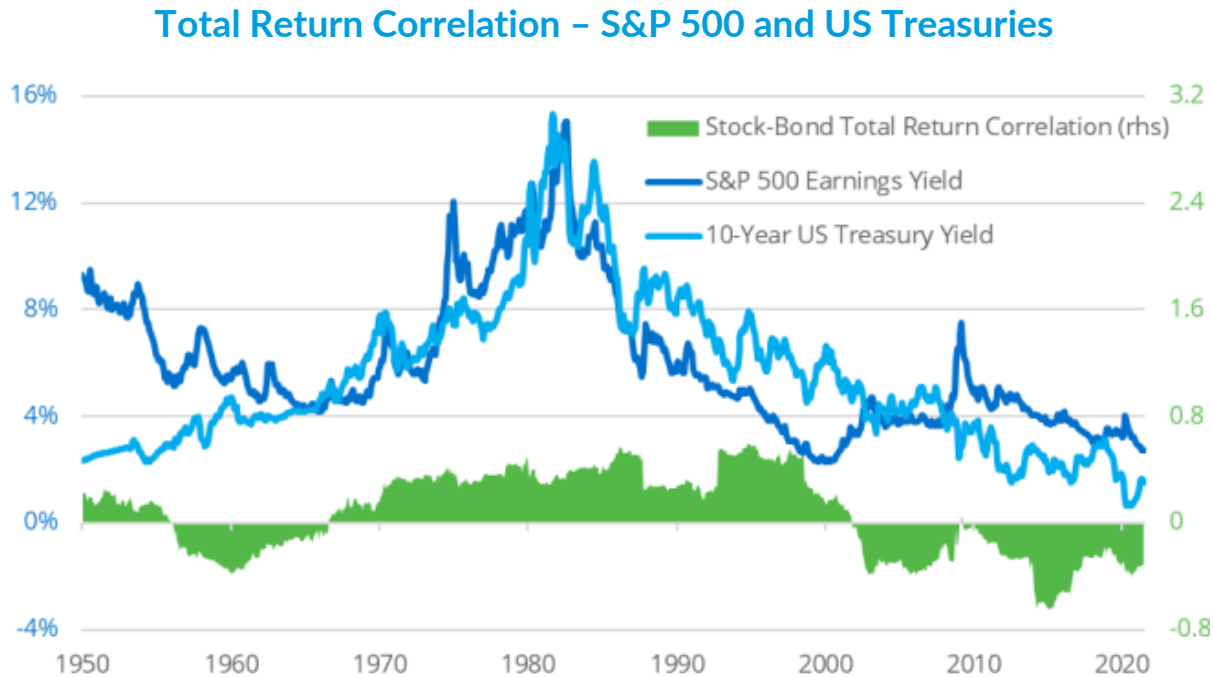


#2: We recommend you favour value over growth in your equity portfolio.

Average Annual Real Returns in Years with Above-Median Inflation The US, 1927-2020



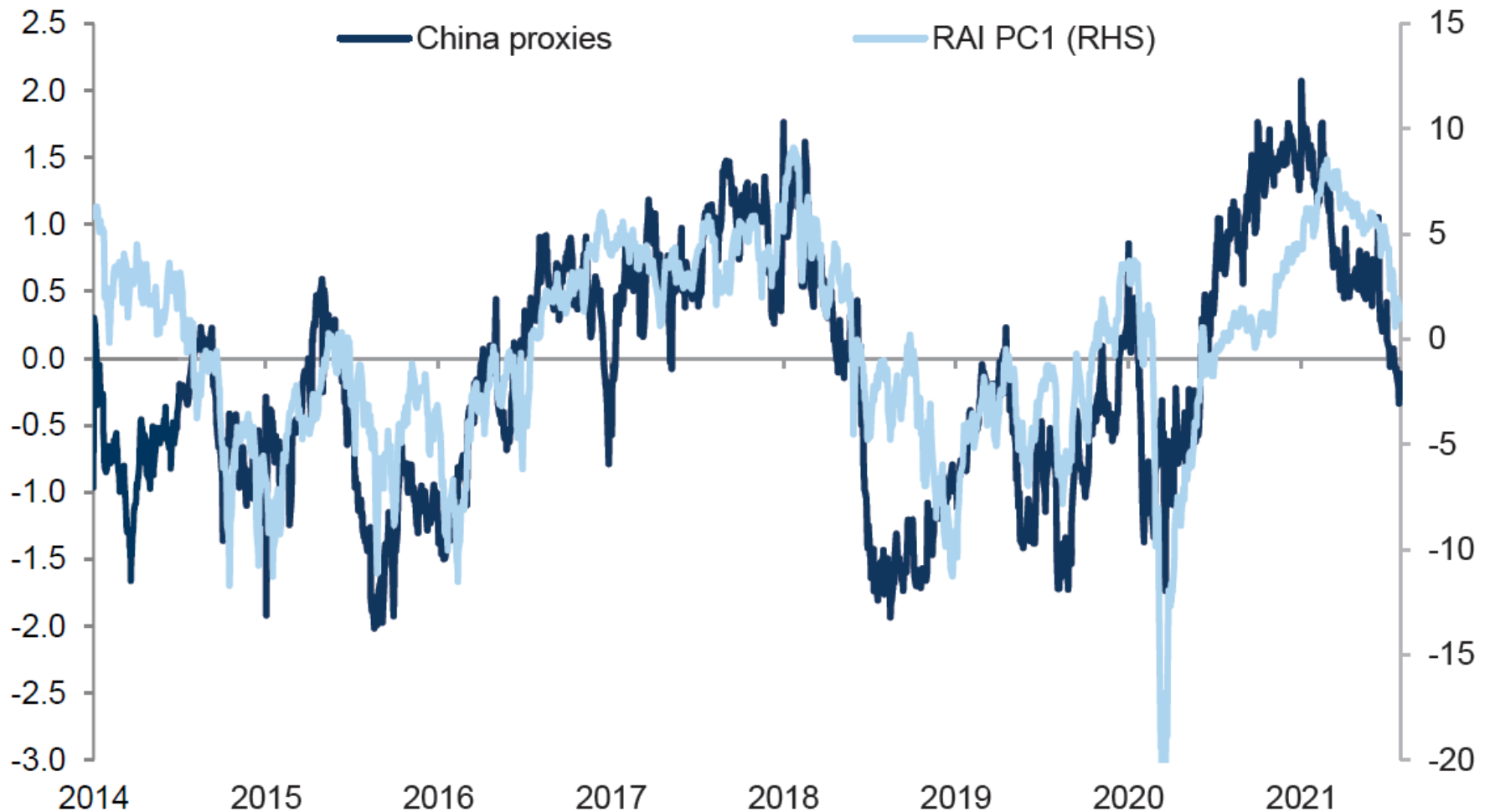
#3: We recommend you deemphasize the traditional 60/40 approach, which has worked so well over the last 20 years.



- For the last 20 years or so, investors have relied on the negative correlation between bond returns and equity returns for diversification and protection during times of turmoil.
- That relationship is about to turn positive again, making one of the most popular features in the investment industry – the 60/40 portfolio – much less attractive.
- If cashing in, will investors be selling their bonds or their equities?

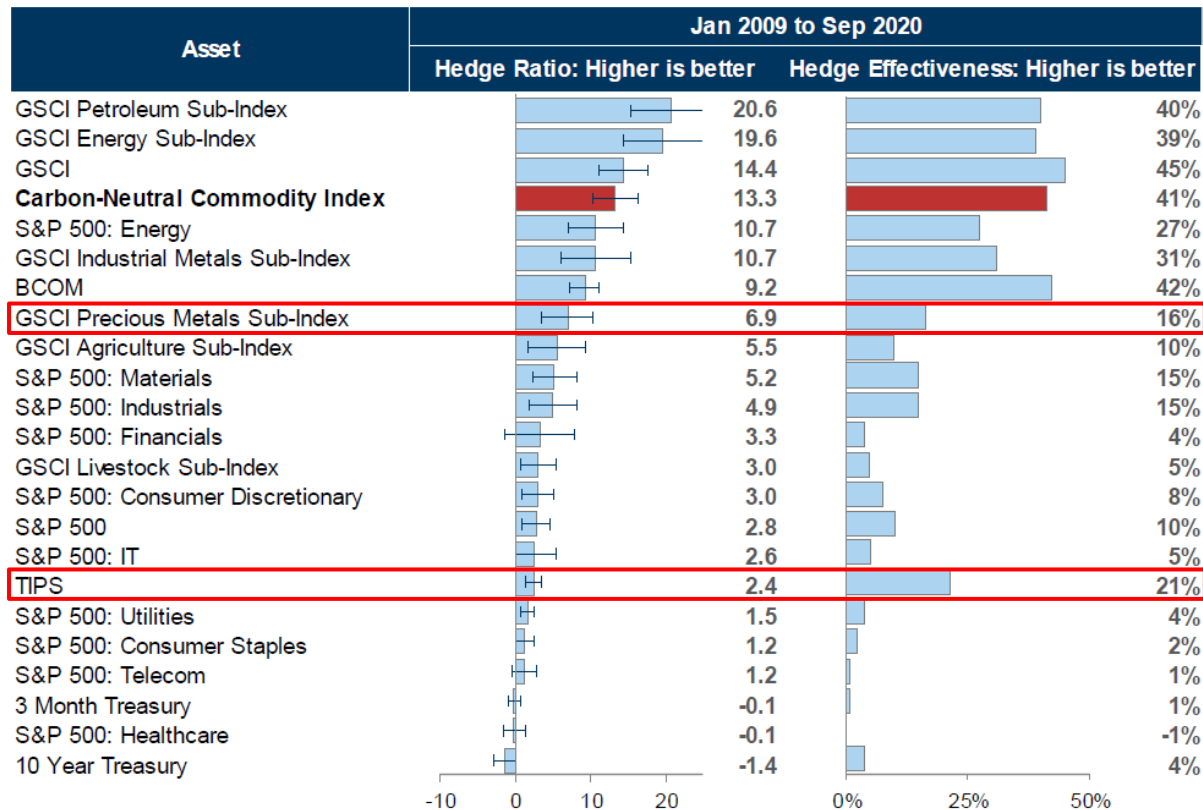
#4: We recommend you reduce your long-exposure to China. Chinese fortunes are closely linked to global GDP growth, and China suffers when it is low or negative.

Global Growth vs. China Proxies
RAI PC1 vs. Average Z-Scores

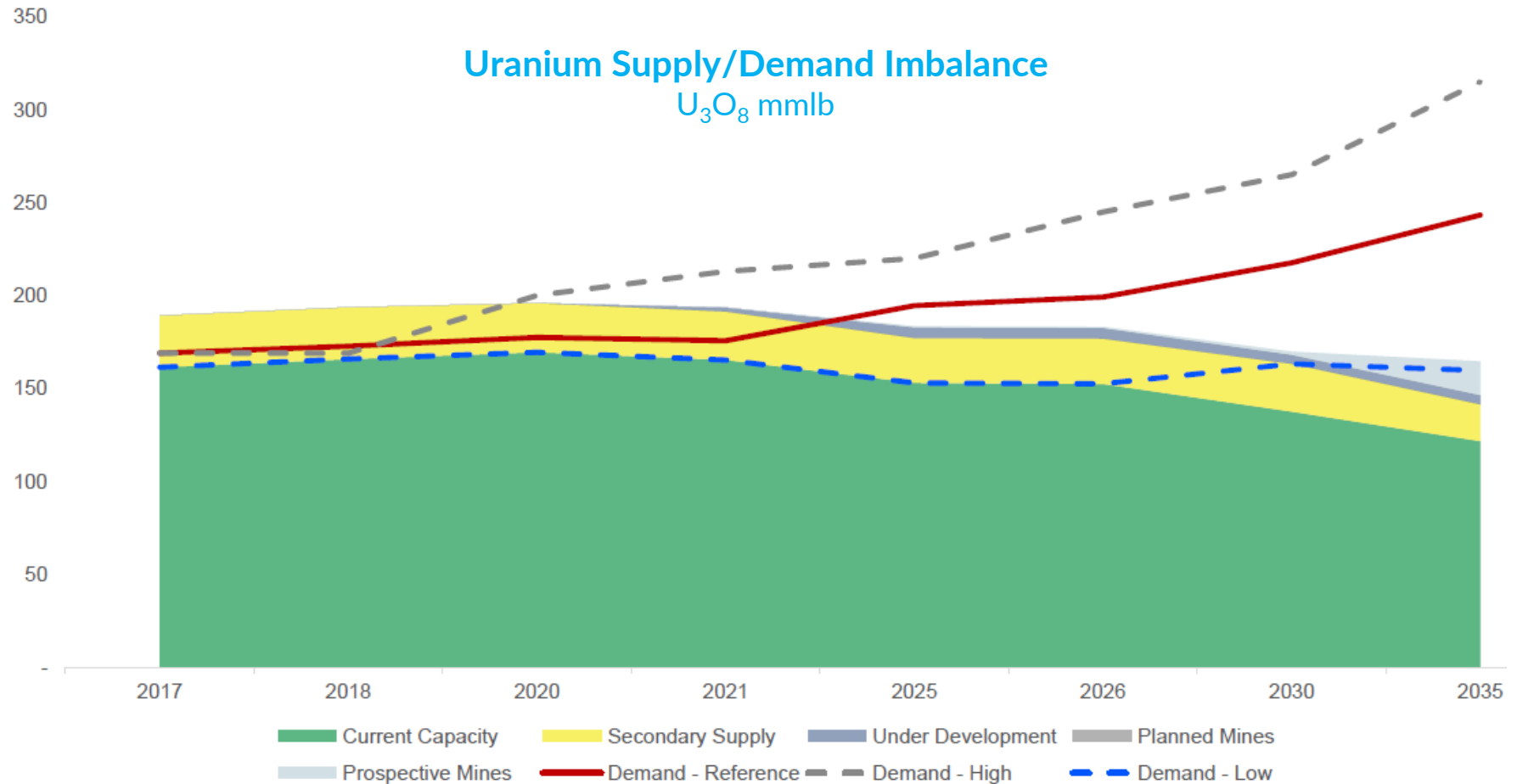


#5: We recommend you don't invest in inflation-linked bonds, nor in gold, unless you think the inflation outlook is even worse than we think it is.

- 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.



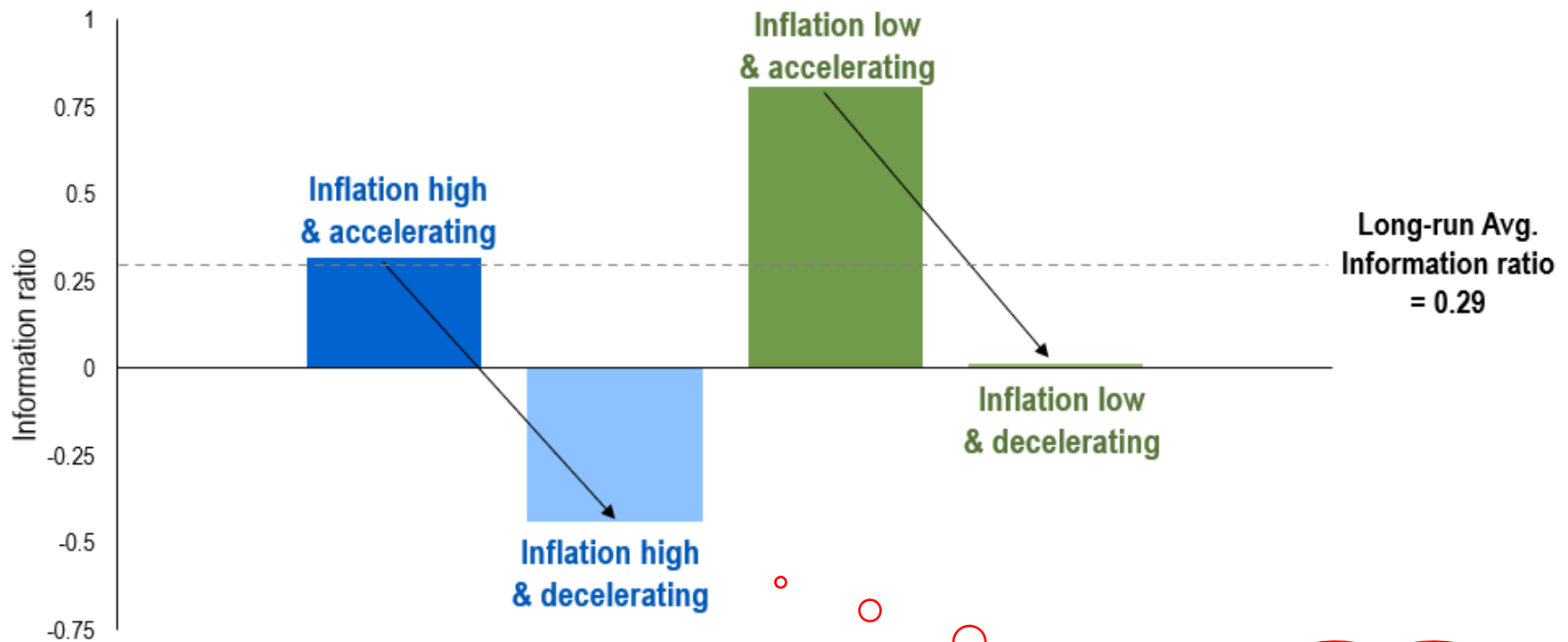
#6: We recommend you add uranium to your portfolio. Both demand and supply are highly predictable, and demand will exceed supply for years to come.



#7: We recommend you reduce your exposure to industrial commodities (ex. energy).
They rarely do well when central banks go to war against inflation.

Information Ratios of Commodities during Different Inflationary Regimes

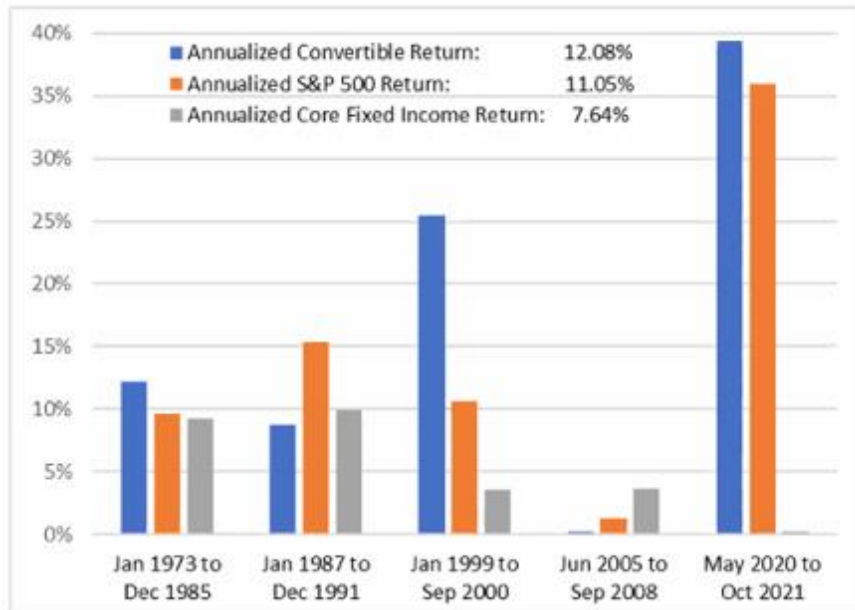
Hypothetical Long-Only Commodity Portfolios, 1972-2021



Commodities have performed poorly in previous hiking cycles.

#8: We recommend you increase your exposure to convertible bonds. They have outperformed both bonds and equities during inflationary periods over the last 50 years.

Returns on Convertible Bonds in Inflationary Periods



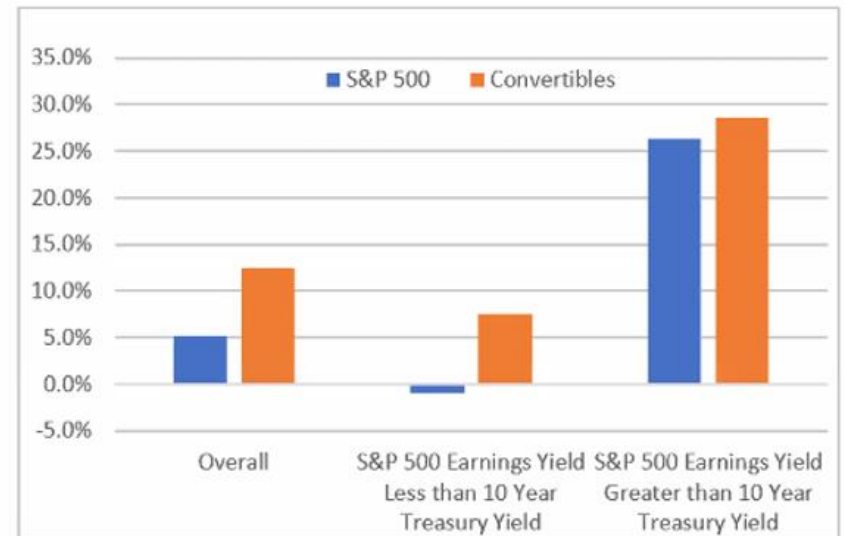
Inflationary Periods	Peak CPI	Convertible Return	S&P 500 Return	Core Fixed Income Return
1/73-12/85	14.8%	12.2%	9.6%	9.2%
1/87-12/91	6.3%	8.7%	15.3%	9.9%
1/99-9/00	3.8%	25.5%	10.7%	3.5%
6/05-9/08	5.6%	0.2%	1.3%	3.6%
5/20-10/21	6.2%	39.4%	36.0%	0.2%

#8: (continued) ... convertible bonds have done particularly well when equity P/E ratios have been elevated, and that is precisely what they are now.

Performance across P/E Ratio Buckets

PE Ratio (Beg. Of Month)	S&P Return	Conv. Return
Low: 10 to 15	21.7%	13.8%
Moderate: 15 to 20	11.2%	7.9%
High: 20 to 25	10.4%	13.8%
Highest: 25+	5.2%	12.4%
Total	11.4%	10.8%
Highest PE minus Moderate PE	-6.0%	4.5%

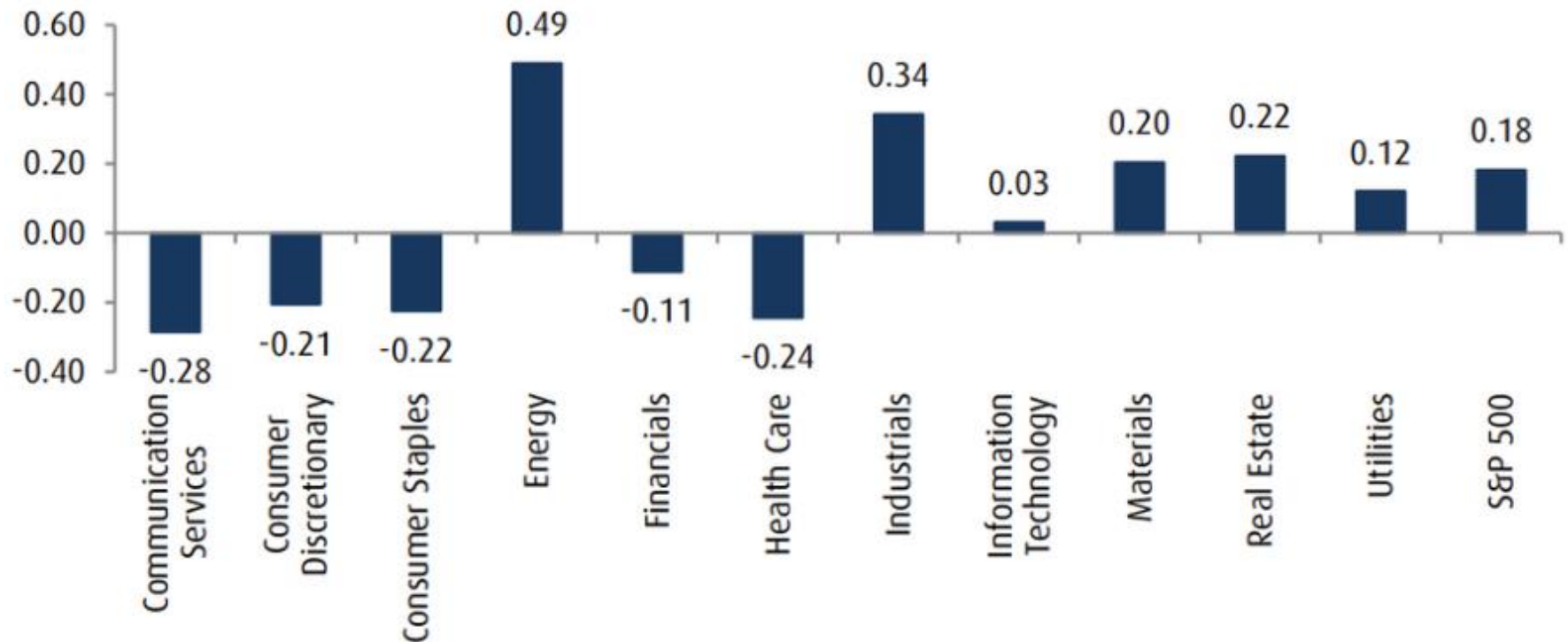
Returns when S&P 500 P/E Ratio Exceeds 25



#9: Finally, the joker: energy stocks. They perform well when inflation is above average, and low capex in the energy industry could drive returns even higher.

Correlation Between Relative Sector Returns & US PPI Minus US CPI

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



Part 3

ADDITIONAL OBSERVATIONS



Additional observations.

- Equities rarely do as poorly in hiking cycles as the bears expect. Since 1962, US equity returns have annualised 8% in high-inflation regimes and 15% in low-inflation regimes, i.e. equities have delivered respectable returns, even when inflation has been above average, so you shouldn't walk away from equities. It is just a question of re-arranging your portfolio. The biggest exception to this is the big bear market in the late 1970s and early 1980s, when inflation was out of control. That is the big risk now.
- Over the past couple of years, our favourite inflation trade has been industrial commodities, and that has worked very well for us; however, industrial commodities rarely do well when central banks go to war against inflation. It could be different this time, though, because of the green transition, so it is a difficult call to make.
- Our base case scenario for (late) 2022 is a hard landing in the US, so a defensive portfolio construction stance is warranted. In such circumstances, value stocks should replace growth stocks and uranium, lithium, copper and other green metals should account for most of your commodity exposure. You should also add convertible bonds to your portfolio in lieu of equities and straight bonds.
- The biggest joker going in to 2022 is fossil fuel companies. Record low capex in the energy industry could very well lead to insufficient oil and gas supplies, which could again lead to higher prices in the short-term despite the long-term outlook being very negative.

Appendix

THE SIX MEGATRENDS



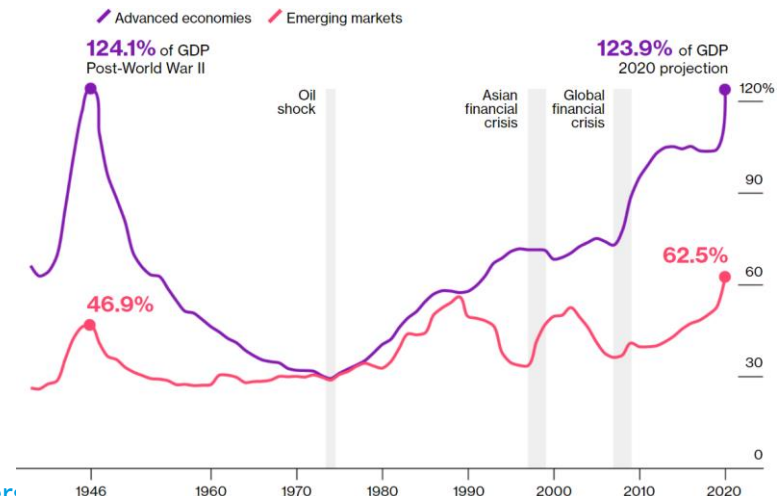
Megatrend #1.

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 Δ Productivity and Δ GDP 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)

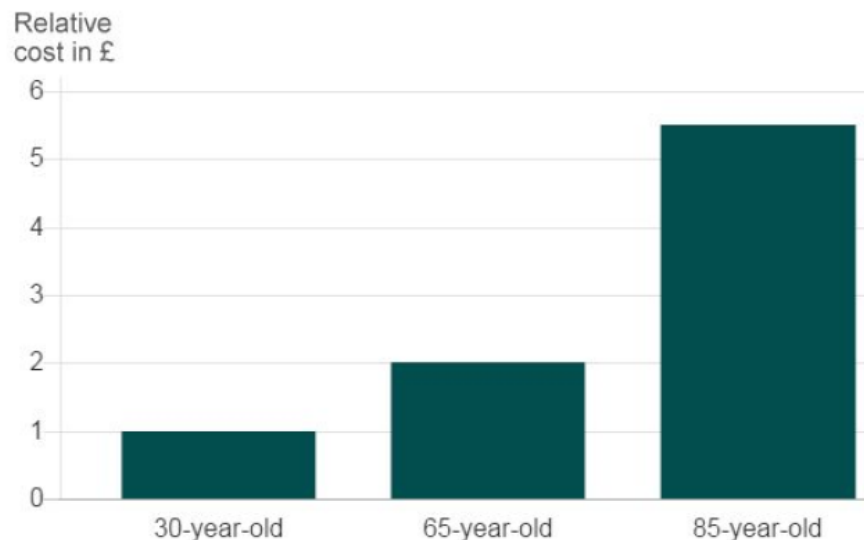


Megatrend #2.

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



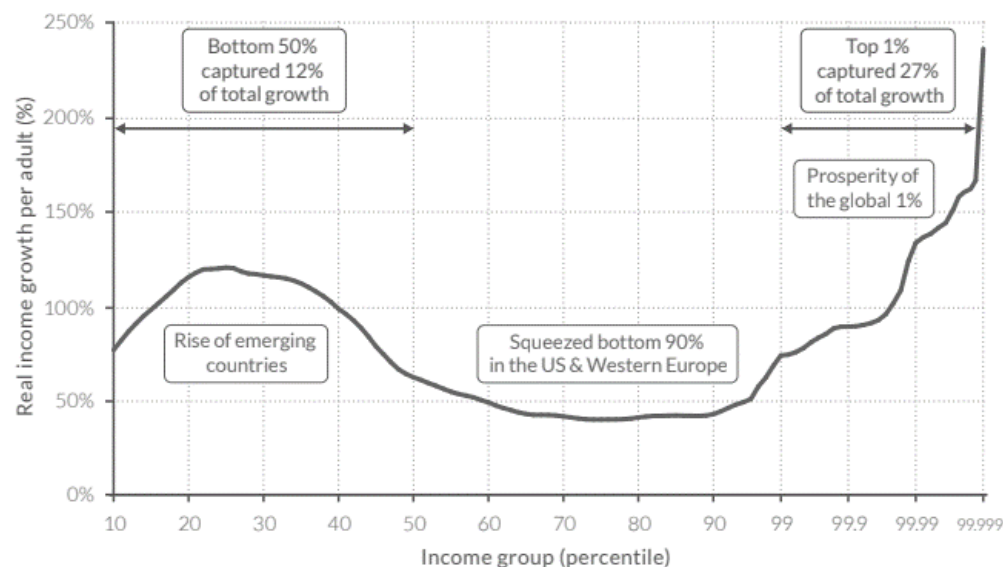
Megatrend #3.

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 partially 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 growth in the Chinese economy without being exposed to the over-leveraged financial system in China.



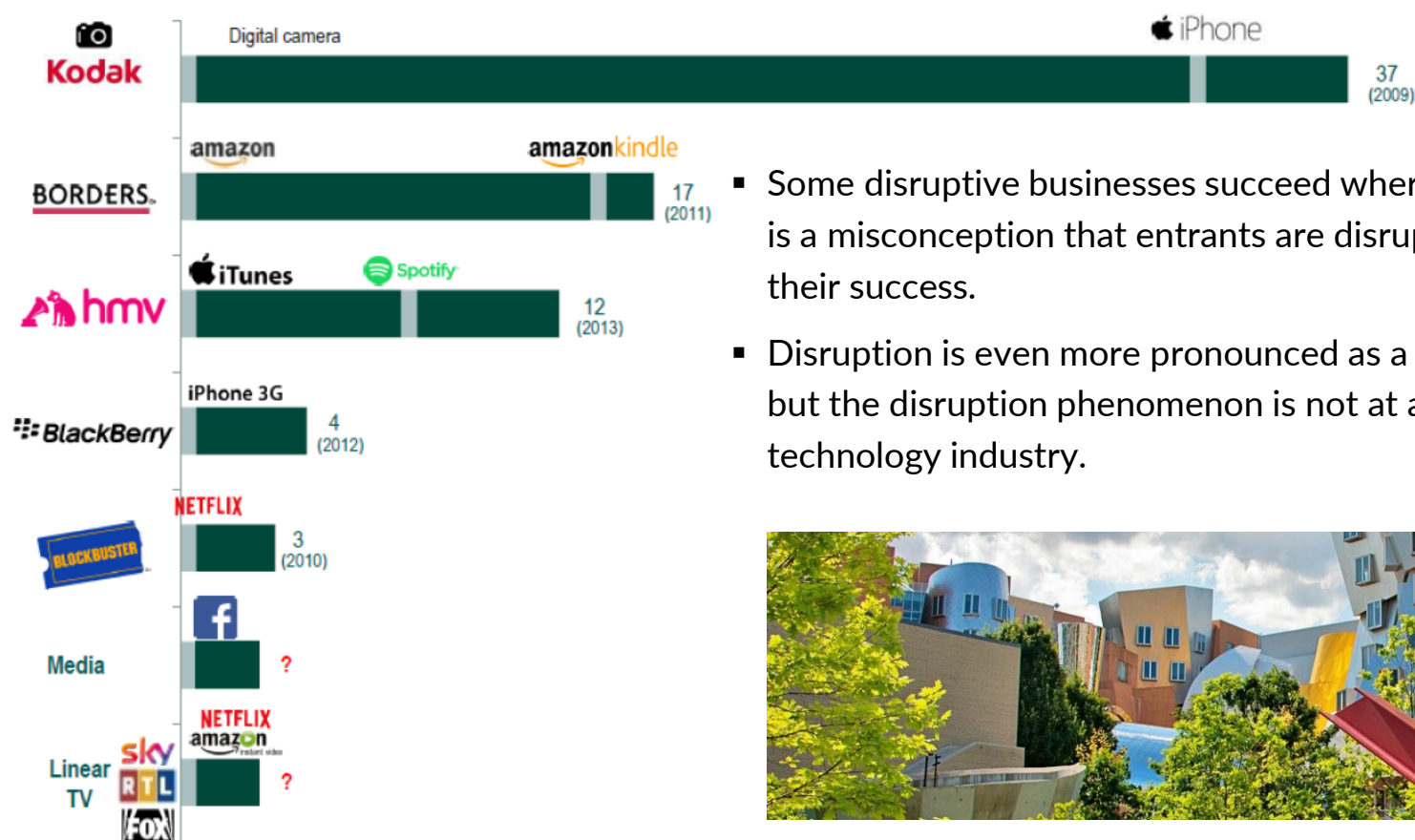
Chinese GDP Catch-Up under Various Assumptions

		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual	1.00%	2047	2032	2027
US GDP	1.50%	2057	2034	2028
Growth	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.

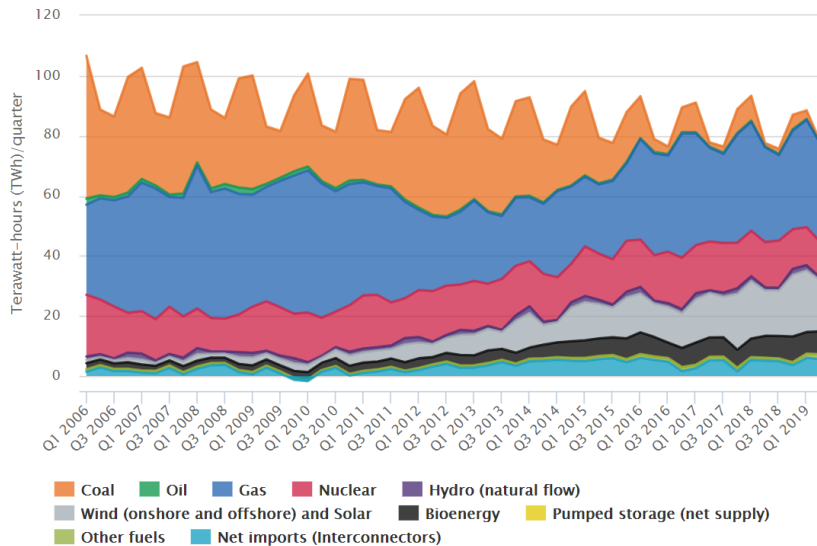


Megatrend #6.

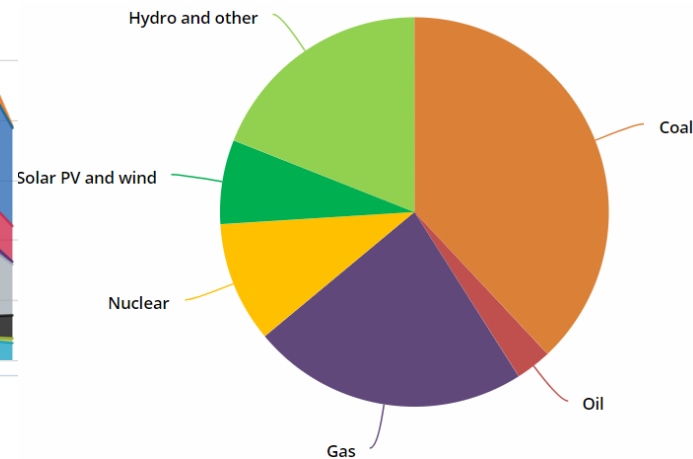
Climate Change

- 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 30/06/2021) 623% of US nominal GDP.



Total US Household Wealth-to-GDP since 1947



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