M1 CAPITAL
INVESTMENT MANAGEMENT

Is Inflation Here to Stay? – Commentary September 2021

September saw market declines worldwide and South Africa was not an exception, though it performed relatively better in ZAR terms vs its USD return. In USD terms South Africa now outpaces Emerging Markets by about 10% but is behind Developed Markets represented by the MSCI World. Globally the market declines saw Value outperform Growth, as might be expected, while from a geographic perspective the US continues to lead. These various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for September 2021*

	Sep-21	YTD 2021
FTSE/JSE ALSI (ZAR)	-3.1%	12.2%
FTSE/JSE ALSI (USD)	-6.9%	9.6%
MSCI World	-4.2%	13.0%
MSCI EM	-4.0%	-1.2%
MSCI Value	-3.0%	13.8%
MSCI Growth	-5.2%	12.0%
S&P 500	-4.7%	15.5%
Nasdaq 100	-5.7%	14.6%

*Total return indices, Source: Factset

This month we consider an issue that is exercising investment and economic minds around the world – what are the prospects for sustained inflation and what are the implications of sustained vs transitory inflation? This article starts with a disclaimer – the M1 Capital investment process is not focussed on predicting macroeconomic outcomes, therefore we have no particular value to add to the debate. It may be instructive, nevertheless, to consider what the collective wisdom of financial markets appears to be saying on the matter. What is certain also is that how inflation and interest rates unfold will have tangible impact on the performance of M1 Capital funds.

We also note that well-known economic and market personalities appearing in the global financial media unanimously appear to be calling for persistent and/or stronger than expected inflation. They also frequently seem to suggest that the US Fed is committing a policy error in its management of monetary policy.

Finally in this preamble we mention famed hedge fund manager Stanley Druckenmiller saying that "the inside of the stock market is the best economist I know". We too, hence, look to the markets for clues.

With the intention of being brief we will consider three indicators – US money supply, commodity prices and bond yields.

US Money Supply

Even the most casual observer would not have failed to have been impressed by the steep increase in money supply growth seen in the US in 2020. This, of course, came as policymakers were scrambling to contain the economic effects of the virus. Escalating at its peak at an unprecedented nearly 30% p.a. this was the harbinger and, indeed, driver of what was to come. This US money supply growth rate is presented in Chart 1 below.

Chart 1. US M2 money supply growth rate p.a.

Source: Factset

The growth rate has, however, since moderated significantly - still high by historical standards, but less than half the peak rate achieved at the beginning of this year.

Commodities

Commodity futures markets are among the most liquid in the world. Commodities are also a real asset – all else being equal a particular commodity's price in nominal terms will adjust to a change in money supply. Commodities are therefore among the most rapid responders to expected inflation. And so it happened, in 2020, as commodity prices adjusted rapidly upwards to the increase in money supply and expected inflation. For purposes of example, we specifically consider Gold, Platinum and Iron Ore, which increased 28%, 42% and 156% respectively to their peaks.

Commodities too, however, have since declined – Gold is down -8%, Platinum is down -15%, and Iron Ore is down the most at -43%, after rising the most.

These respective commodity price movements are set out in Chart 2 below.

Chart 2. Commodity price movements – Gold, Platinum and Iron Ore

Source: Factset

Incidentally in responding to money supply growth, higher commodity prices feed into manufacturing and construction to reinforce the inflationary impulse.

In contrast, it is also no accident that higher real estate prices only reached media headlines in the second quarter of 2021 – the real estate market is one of the least liquid and takes the longest to respond, and even then only after being subject to a higher cost of inputs as higher commodity prices took time to feed into higher real estate costs.

Bond yields

Finally we consider US Treasury yields – the all-important interest rate benchmark. These have followed a consistent downward trend since the US Fed began controlling inflation through interest rate adjustments in the early 1980s. The US 30-year Treasury yield is presented in Chart 3 below.

Chart 3. US 30-year Treasury yields

Source: Factset

The sustained downward trend is clearly visible along with sharp temporary declines in times of crisis – 2008 in particular, and again early in 2020. A bond yield anticipating inflation would be rising, which the 30-year Treasury yield clearly is not, although markets certainly became excited in March, in anticipation of such an increase.

So in summary the most liquid and inflation-sensitive markets are clearly not anticipating inflation, or at least not yet. What about equities?

Implications for Equity Returns

The Value / Growth divide in listed securities appears to be quite pronounced, though we note, as always, Warren Buffet's comments that Growth and Value are not contrasting approaches to investment but two sides of the same coin. For purposes of example however we adhere here to the Value / Growth construct.

If the bond market begins to recognise sustained inflation as a realistic prospect and yields rise, this will lead to declines in equity valuations. In theory, as the interest rate structure moves up, all equities will be affected as the discount rate used in valuation increases and the present value of future profits declines. The argument that growth-type shares will be more affected does, also, have merit. In theory a company which is not yet profitable but expects to be so in the future, or a strongly growing company, will both have more of their profits realised in the future. The same discounting factor therefore will have greater

impact than on a mature company with more stable cash flows. In technical terms this aspect of valuation is referred as discounted mean term or duration. Longer duration assets are more volatile and their prices rise more when interest rates rise and decline more when interest rates decrease. In an increasing interest rate environment, therefore, companies with better prospects will likely decline more in percentage terms, though the relative decline will have to be balanced against the prospects of less well-performing assets.

Should interest rates not increase, the current dynamics will likely persist and better operationally-performing assets will likely continue to perform without material de-rating.

The M1 Capital investment process is cognisant of valuation considerations but not exclusively focussed on these. Rising interest rates are therefore likely to affect M1 Capital funds more than pure valuation-focussed funds. Should this scenario arise, we expect that over the longer term, over and above short term valuation impact, better quality assets will nevertheless still outperform.