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LUTHER KING CAPITAL MANAGEMENT

Research

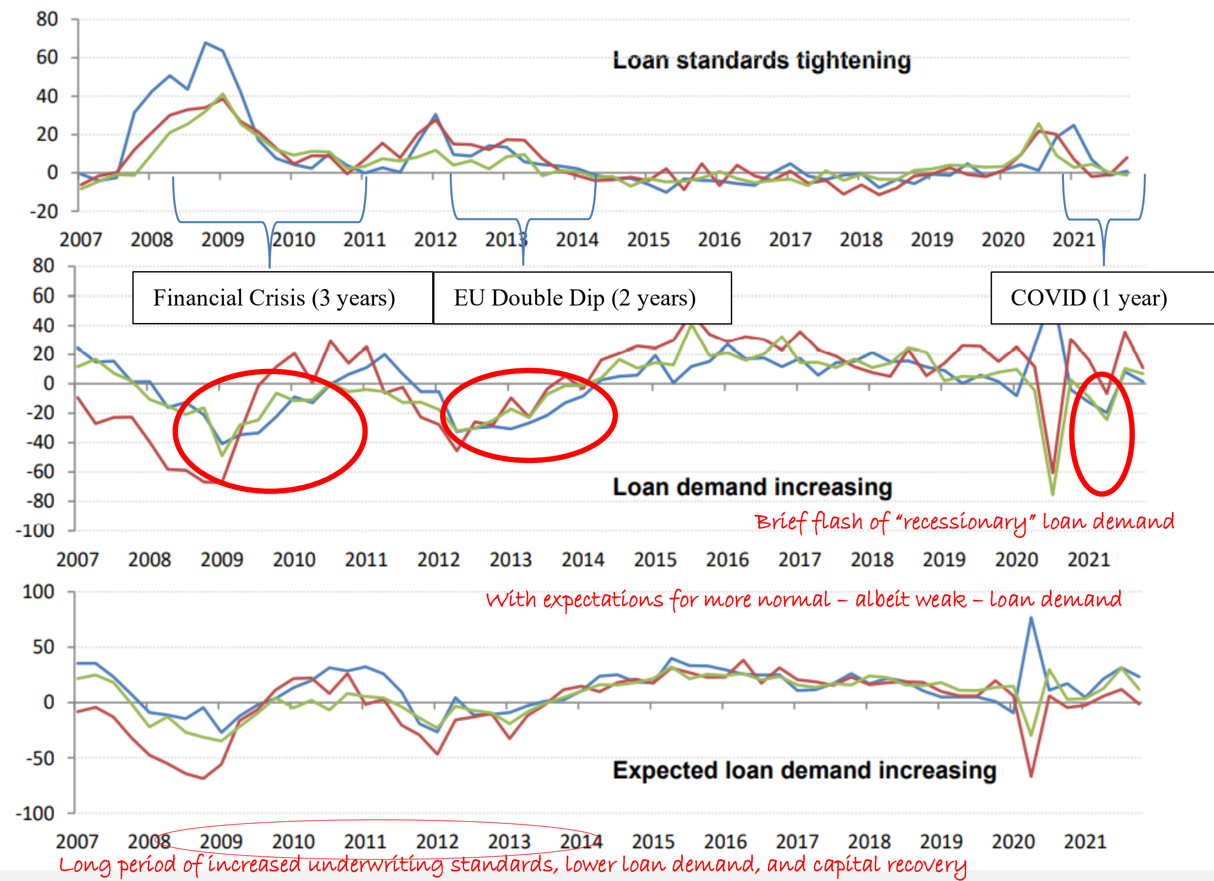
Third Quarter 2021 Review: International Equities Strategy

Economic and Capital Markets Commentary

As we have moved through the Delta wave of the pandemic, the focus turns towards the challenges with responses in the supply chain. Demand remained surprisingly strong as a result of extraordinary monetary and fiscal stimulus, and asset prices have benefited from historically low interest rates. The mismatch in supply and demand has prompted a price response by managements as they struggle to both satisfy customers and preserve margins. Economists have adopted increasingly divergent outlooks on how global markets will respond to these forces. As the outlook remains uncertain, our team feels like we are watching things unfold in slow motion. Views continue to be constructive in the short term with resilient demand, but longer term forecasts into inflation, growth, and rates, which will ultimately be our destination, exist beyond the purview of the current economic lens.

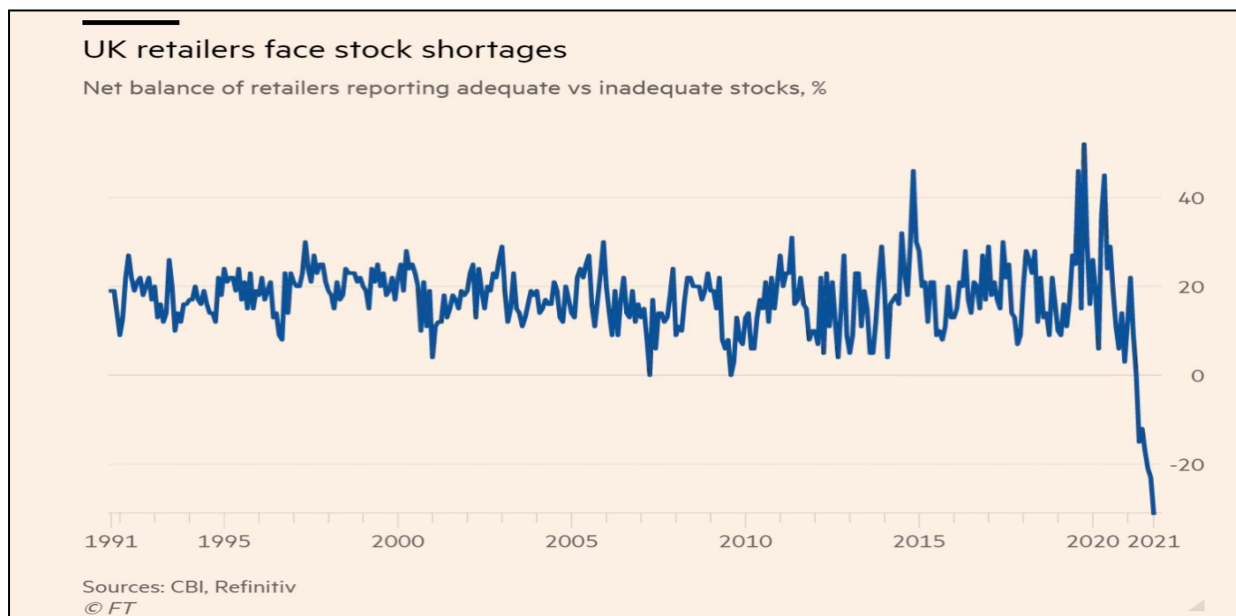
Moving further into a recovery, COVID still remains a risk to global manufacturing, active employment, resource availability, and economic activity. Globally, new cases have been trending downward after reaching another "wave" peak in August, dropping approximately 33%. While these aggregate numbers indicate encouraging progress, some regions have recently risen again, such as Germany and the United Kingdom, highlighting a persistent risk as we attempt to drive incremental economic output. Currently, data series estimating economic activity in Europe have returned to pre-pandemic levels after a pause in August, and activity in Germany and the U.K. remain resilient, despite the recent increases in new cases.

Though the pandemic risks persist, we now must turn our focus further towards the challenges posed in a supply constrained environment. Extraordinary monetary and fiscal response has promoted consumption, lowered cost of capital, and strengthened balance sheets, while avoiding more persistent capital impairment resulting from labor market slack, tighter credit conditions, reduced liquidity, and decreased demand. Underwriting and credit trends exhibit some of the ways that many economies have avoided systemic paralysis prompted by capital adequacy and availability. With ample financial resources, domestic demand in Europe has recovered to only 4% below pre-pandemic levels. After the Financial Crisis commenced in 2008, this level of nominal demand didn't permanently drive through this level until 2014.



Source: Trend Macrolytics LLC

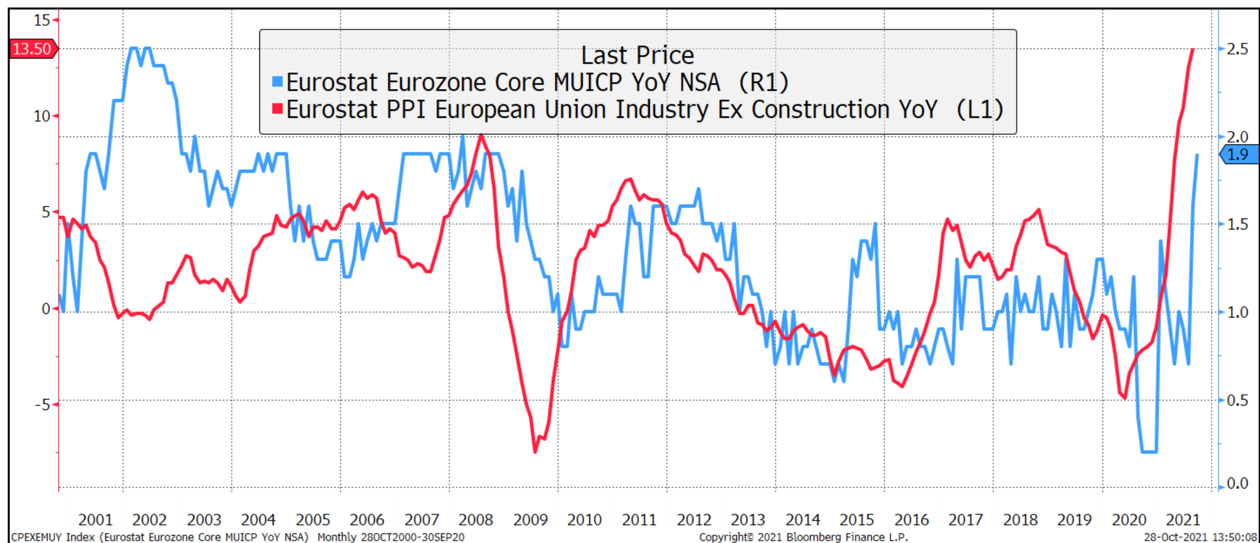
The resilience of demand, promoted by stimulus, has led to price increases as supply chains have struggled to respond with depleted inventories. The needs to replenish these inventories will likely drive a second stage of economic growth, as purchases exceed sales in order to restock to satisfy existing consumption. While driven initially by elevated prices in commodities, financial assets, and select items (e.g. transportation), risks have developed that these increased prices become more structural as this incremental demand continues to outpace any alleviation of supply constraints.



Source: Financial Times

Recent headlines focus on energy's impact on transportation and utility prices. While other areas like China and the United States have seen energy inflation, Europe is currently the largest impact zone for these prices as spot prices for delivered LNG had moved above $20.00MMBtu (versus $5.80 for Henry Hub contract). Their aggressive shift towards renewables as a percentage of their power mix, without providing sufficient capital resources for reliability through utility scale storage or reserve supplies of "brown" energy, has left both consumers and companies vulnerable to high prices and uncertain supply. While the Nord Stream 2 pipeline and some posturing from Russia could contribute, low storage inventories globally belie a strained supply and demand environment with Europe as the proverbial canary.

Though these headlines are dominant, we expect that volatility in energy won't translate directly to sustained levels of inflation. Energy can act as a catalyst but is widely dismissed as a cause for structural inflation. Unfortunately, energy supply does impact prices and demand, as production costs for goods increase and the energy "tax" exacts a toll on discretionary spending. The chart on the following page shows the European PPI (Producers' Price Index) and Core CPI (Consumer Price Index), which excludes food and energy. Though PPI tends to lead CPI, they both appear to be continuing to rise. At present, the increases in the European PPI sit at multi-decade highs with some – like in Sweden – reaching levels not seen in the last fifty years, which includes the 70s.



Source: Bloomberg LP

While our base case outlook remains for inflation to return to more benign levels by the end of 2022, price increases have expanded to broader measures of goods and services, and the timeline for transitory inflation has extended. During quarterly calls, management commentary throughout developed markets have uniformly pointed to increases in costs, limited supply, and labor shortages. Recently, global bellwethers Amazon and Apple warned that supply chain disruptions present obstacles on their ability to achieve potential revenue. Bond markets have also taken note, as yields have increased in response to the threat of more persistent inflation. These yields fell as the Delta-wave casted doubt into domestic demand and prompted considerations for prolonged accommodation. Demand has proven resilient, and yields have risen again as the supply side of the equilibrium has returned to be the central focus.

Source: Bloomberg LP

In our past reviews, we highlighted the challenges in the labor market, and these have the potential to drive additional increases to costs. Though unemployment remains above pre-pandemic levels, other indicators, such as job openings-to-unemployed ratio or the Beveridge Curve (vacancy rate-to-unemployment rate), exhibit an unusual tightness for this stage in an economic cycle. The increases in the price of goods, along with food and energy, undermine the purchasing power of nominal wages. These pressure on non-discretionary, household spending, combined with the tightness in the marketplace, will drive wage growth to levels not normally experienced at this point in the cycle. Labor cost inflation has not been a challenge for companies over the last few decades, and the labor share of corporate profits has been in structural decline. As wage pressures surface with increased negotiating leverage, managements could raise prices further to protect margins and returns, introducing the prospect – albeit still remote – of a wage/price spiral and the resurrection of the Phillips Curve, which demonstrates an inverse relationship between unemployment and inflation.

Economic forecasts remain challenged, though we do expect corporate earnings to grow in 2022. As we move into 2022, we will likely gain better visibility into three potential outcomes: inflationary boom, stagflation, and transitory inflation. In an inflationary boom, growth in economic output will continue despite increases in prices, but central bankers will respond with measured increases in rate policy and quantitative easing. Rate increases would be greater than currently predicted, but high levels of liquidity and capital in the economic system would allow ample access to drive both supply response, as well as supporting demand. Yield curves will steepen as higher inflation impacts expectations for long term rates. In the event of stagflation, inflation cools demand, but imbalances with supply drives goods prices higher. Gains in productivity, capital deepening, and globalization of supply chains have prevented any risk of such a Malthusian outcome for decades. A few bold economists have recently raised the specter of such an outcome. Central bankers would be forced to raise rates to address inflation despite the weak economic backdrop. This scenario would be the most debilitating to asset prices, which have enjoyed demand growth, low discount rates, and strong returns for many years. We believe that this outcome is unlikely.

The current consensus appears to coalesce around the prospects for transitory inflation. In this scenario, strains in the supply chain would be alleviated as normal activity resumes. Tight labor markets would not prompt labor-driven inflation, and productivity gains would again save the day, as companies deploy capital to increase capacity and mitigate wage inflation. Rates rise but the yield curve flattens, as long term rates discount manageable, modest levels of long-term inflation. While this is certainly the Goldilocks scenario, it still remains the most likely, and is the most common with a typical economic cycle. There have been some defectors from this outlook, as the term for transitory has extended.

The risk for a central banker would be to alter their policy course prematurely and stymie potential growth. Currently, the Bank of England and the Bank of Canada have introduced more hawkish language, hinting at rate increases ahead of their peers. Alternatively, the European Central Bank and the U.S. Federal Reserve Bank have maintain relatively dovish policies with no changes to their policy timelines. Idiosyncrasies exist between these markets, but taken as whole, their policies will help shape the trajectory of the recovery – both regionally and globally. We will continue to refine our internal forecasts as policymakers approach these decision nodes.

Mason D. King, CFA
November 1, 2021

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