ClucasGray Private Clients

April 2021 Quarterly Commentary

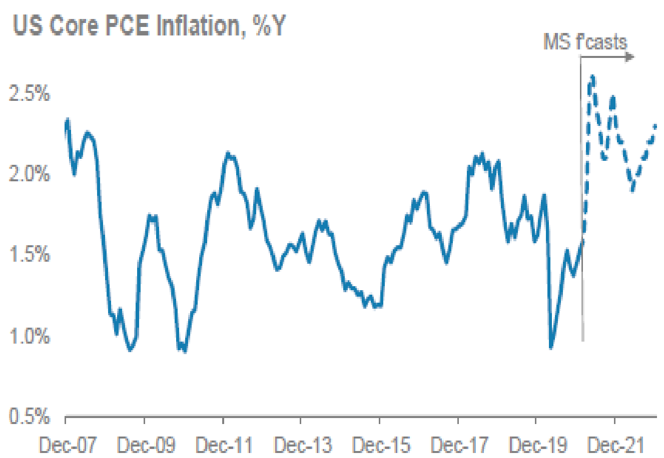
"The future is no more uncertain than the present." Walt Whitman, 19th century American poet

A year in, and much has changed, some changes temporary, others less so. What started out as a novelty of lockdowns, work from home, and a changing social dynamic has seemingly become the norm, for now. None of us can know for sure how the next few years play out – indeed, as Walt Whitman points out, the world has always been filled with uncertainty. Having stared down the economic abyss during the second quarter of 2020, we are relieved that there does appear to be some light at the end of what has been a dark tunnel.

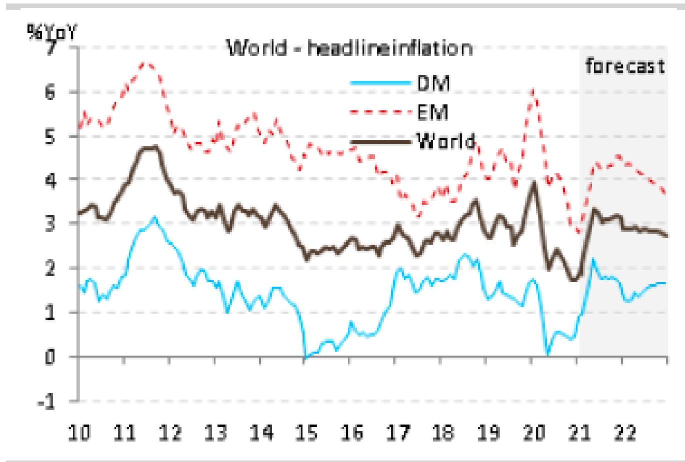
We have decided to focus this quarterly on an investment topic that we have been discussing and debating internally - the prospect of higher ***inflation*** and more specifically what this might mean for portfolios and investors. A seemingly mundane economic topic, one may well ask about its relevance.

Why worry? Periods of unexpectedly high inflation are unwelcome – it erodes the purchasing power of money, and the response to controlling inflation (raising interest rates) influences the cost of debt. This has potential negative consequences for any country, company or household that is highly indebted. Historically, specific periods of unexpectedly high inflation have been disruptive for exchange rates and asset prices – equities and bonds alike.

Aside from isolated examples in specific emerging markets, high inflation was last an issue in developed markets during the mid 1970's and early 1980's where oil shocks were largely responsible for the sharp rise in inflation. In developed economies, inflation has remained largely within the target ranges of central banks for over 30 years. More recently, inflation has tracked below the desired ranges - the left graph below from Morgan Stanley illustrates that inflation in the US has remained below 2% for much of the last decade, and the trajectory of global inflation (graph on the right from UBS) has been a picture of steadily declining inflation.



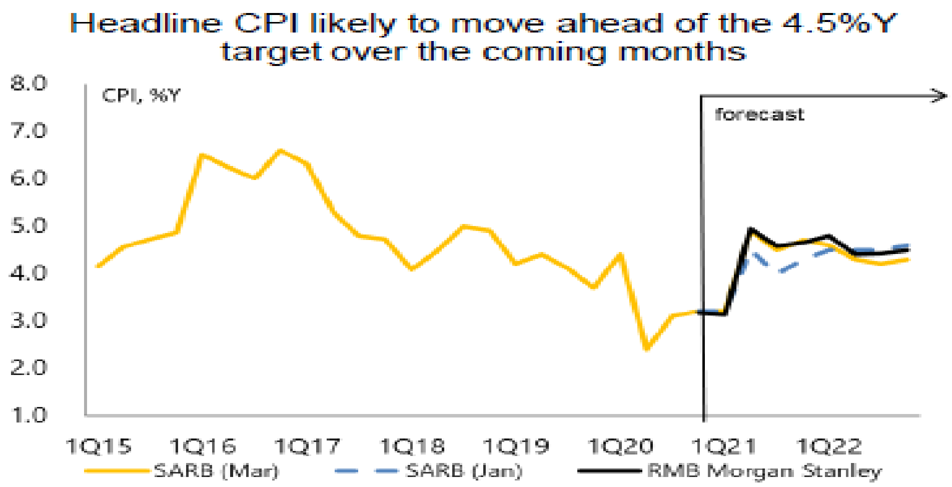
Source: Haver Analytics, Morgan Stanley Research forecasts



Source: UBS, Haver

This does not mean that we should be dismissive about the risks and the possibility of a sharp move in inflation – it could illicit undesirable responses from central banks and negative knock on effects for assets prices. Much of the recent concern about the prospects of rising inflation has been driven by the fact that governments around the world have taken extreme monetary and fiscal measures to stabilise economies and the incomes of households. These measures have the potential to become inflationary, but the outcome of high inflation is not a foregone conclusion. As the world continues to emerge from the crisis, additional risks from the combination of global monetary stimulus, possible supply chain disruption and high savings rates, may yet emerge. However, for now the global picture appears to be one of rising but manageable inflation.

On the domestic front, our sense is that a similar picture could unfold – CPI will move higher but is anticipated to remain within the levels of the Reserve Banks' target range. Energy, currency or food shocks are ever-present risks. We expect interest rates to move up in due course, but gradually an aggressive rate hiking policy seems unwarranted at present. We have previously alluded to the fact that high interest rates in South Africa have been an impediment to better growth. A more sustained period of lower rates bodes well for ongoing economic recovery.



In assessing the risks to the inflation landscape and whether any additional portfolio action may be required, we think that it is important to understand a) why inflation is rising and b) whether the risks to inflation may be short-term or more permanent in nature.

The temptation is to focus on the potential negative consequences of rising inflation. However if the underlying reason for rising inflation is an inherent improvement in economic activity and the levels of demand, then such an environment has historically proven to be a very constructive backdrop for improved GDP growth and, as a result, for the earnings and dividends prospects of companies.

Central banks will likely react to risks which they see to be more sustainable or permanent but will be more sanguine about reacting to risks which are shorter term and may "pass through" over time. At this juncture it should be noted that central banks are hoping for inflation to rise – recovering economies will result in modestly rising inflation, improving wages and in due course will allow them to raise exceptionally low interest rates, giving them some "fire power" to act in the future.

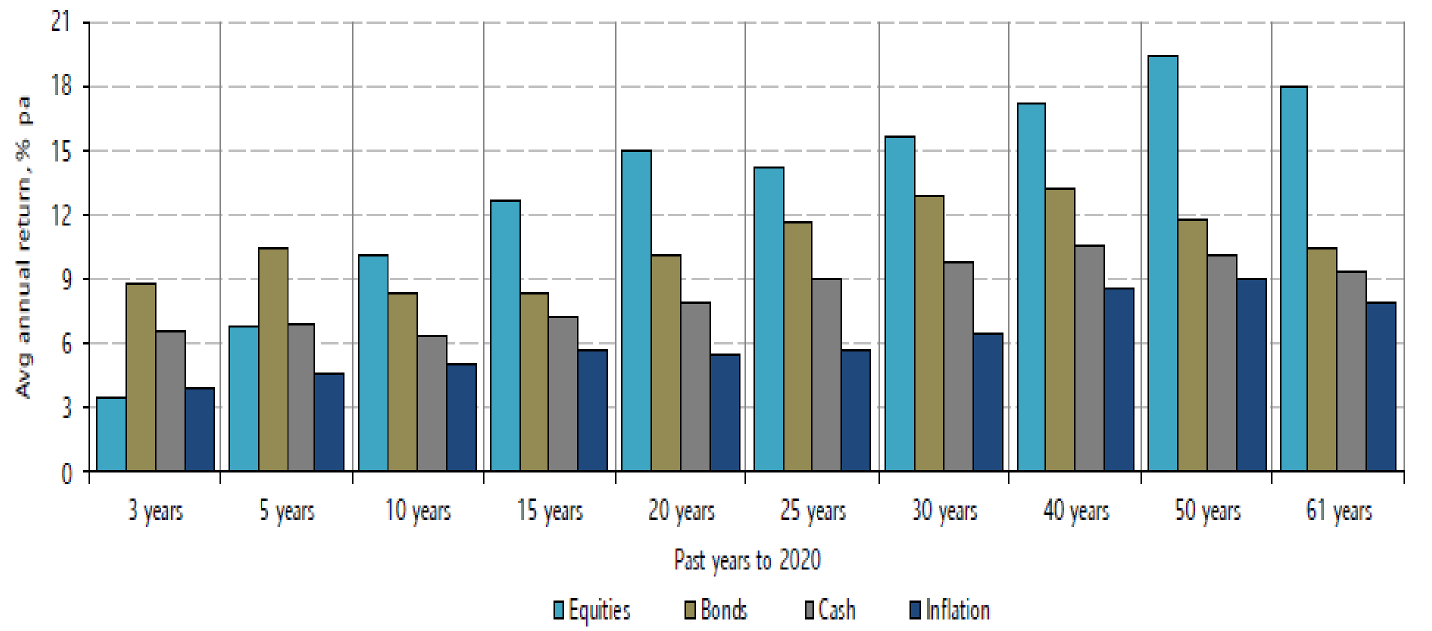
Our sense is that central banks remain firmly committed to supporting both the economic recovery and labour markets. They will need to see convincing evidence that inflation could *sustainably* remain above desired levels before they consider hiking interest rates. In most developed economies, this seems unlikely to occur before 2022.

Investment Implications

One of our key objectives in managing client portfolios is to grow investment returns (and income) ahead of inflation over time. An assessment of the ability of any investment to provide a real (above inflation) return is fundamental to our process.

For South African investors, we find the table below (from Deanne Gordon: SBG Securities) particularly instructive. It illustrates quite clearly that over *extended* periods of time, investors have been well shielded and protected from inflation by investing in a combination of asset classes but primarily by investing in equities.

Figure 12: SA broad asset class average annual total returns (1960 – 2020)



Source: IRESS, FactSet, SARB, SBG Securities analysis

Apart from the last 3 years, domestic equities have manged to consistently beat inflation. Investors will know that aside from resources companies and a handful of other specific examples, the last 3-5 years have been a particularly tough environment for South African companies to grow earnings. Our base case is that the landscape for earnings is improving. Some inflation will help.

The Benefits of Balance

We have written previously about the ability of balanced funds to deliver attractive real returns over long periods of time. To illustrate the point, we have used a hypothetical strategic asset allocation to major asset classes and calculated the nominal and real returns over various periods to 31 March 2021. Over all periods, the compound real returns have been extremely attractive, and evidence that patience would have been well rewarded.

To 31 March 2021	JSE	All Bond	Cash	Property	S&P, Rands	SAA Balanced	Real Returns
CAGR since Dec-15	8.6%	9.5%	**6.8%**	-6.8%	12.5%	9.1%	**4.6%**
CAGR since Dec-10	10.7%	7.8%	6.3%	**4.1%**	21.0%	12.5%	**7.5%**
CAGR since Dec-00	14.2%	9.7%	**7.8%**	13.1%	9.1%	12.4%	**7.0%**
CAGR since Dec-90	14.4%	12.3%	**9.6%**	11.3%	15.0%	14.6%	**8.1%**
CAGR since Dec-75	17.9%	12.1%	**10.3%**	12.1%	15.8%	16.5%	**7.6%**
Strategic Asset Allocation	**45.0%**	**17.5%**	**7.5%**	**5.0%**	**25.0%**	**100.0%**	

Source: ClucasGray Asset Management, March 2021

CAGR = Compound Annual Growth Rate

SAA Balanced = Strategic Asset Allocation Balanced

The other key take away for us, is that asset class leadership in any particular period changes – some periods are dominated by global equity, some by property and others by the JSE. Within global or domestic equities, there are obviously also leadership changes across different sectors or industries. The ability to actively allocate between the various asset classes, and position portfolio's appropriately does, we believe, enable active managers to take advantage of opportunities as they present themselves.

Conclusion

"Inflation will move up this year. Our best view however is that the effect on inflation will neither be particularly large nor persistent." Jerome Powell (Federal Reserve Chairman, March 2021)

We are extremely mindful of the risks that still abound as the world continues to emerge from the crisis. At this point it seems reasonable to expect that global and domestic inflation will rise from current levels and that the trajectory of interest rates globally is upwards. However, we expect central banks to remain patient and do not currently expect sharp, reactionary increases in interest rates. Our investment conclusion is that diversified portfolios, populated with assets that can generate real growth in income streams, will serve clients well and provide them with protection from inflation over time.

Kind Regards

The ClucasGray Team