

# ALVARIUM

## A Two-Speed World Tempts the Inflation Genie

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### Executive Summary:

- As we close the first quarter, we remind ourselves of the extraordinary performance of equity markets from the bear market lows of last year. One year on, most global markets are up 50-60% on average, with an even stronger performance in the US, with the S&P 500 Index up 75% from its March 2020 low and with many technology and more growth-oriented shares up over 100%. **Markets have called the end of the pandemic-induced recession.**
- Markets have remained strong in Q1, with the MSCI World Index advancing by 5%, but leadership has changed, with more cyclically oriented stocks and sectors doing best. Markets outside the US have also done better, with stock markets in Europe and Japan up about 9% on average.
- **Markets are now expecting stronger economic growth for 2021, particularly in the US and China.** Both countries have had success (in different ways) in proactively containing the virus and are now embarking on a new form of stimulus to fuel strategic ambitions and longer-term growth. In our view, the US and China are going to lead the global recovery, with each economy likely to grow by 7-8% in 2021, a GDP growth estimate that is up from 4-5% at the end of 2020 and could well be above average for several years to come.
- **Indeed, we envision a two-speed world in which the strategic ambitions of the world's largest economies will both catapult these countries to greater leadership in many sectors and positively stimulate global GDP growth and investment.** However, their individual quests for growth are also likely to cause geopolitical tensions as two very different systems vie to achieve nationalistic ambitions. The battle lines for leadership in key technologies are likely to take shape over the next few years.
- **We think the years ahead could bring a new phase of economic expansion,** which will be positive for returns, but being in the right sectors and shares will be critical. Stocks leveraged to the strategic growth ambitions of the US and China, and the reopening of global economies more generally, will do well. The recovery will also bring new risks and realities, as rising debts and deficits need to be financed. Proactive government investment financed in part by rising taxation is likely to be the new economic norm.
- **A much-improved level of global GDP growth will cause inflation to rise, certainly from the depths of the recession last year.** Bond markets are feeling the heat. However, while we think yield levels could well rise further from here, we do not see a sustained and uncontrollable rise in inflation – though base effect comparisons may distort near-term inflationary numbers.
- **Indeed, we believe that a range of secular disinflationary factors are still in force,** including demographics of an ageing population, the potential of a supercycle of innovation, improvements in productivity from increased investment spend and the emergence of many new deflationary “business models”.
- **Nonetheless we are in unprecedented territory in terms of fiscal and monetary expansion.** A little inflation is no bad thing, particularly in a world with significant levels of debt to GDP. Too much inflation, however, eats away at returns and can cause disruptions in bonds and equity markets. Markets will remain worried that the inflation genie has been unleashed.

**To achieve real returns above inflation, we think now is the time to remain fully invested,** exposed to the full spectrum of asset class opportunities, mindful of client circumstance. But clients

should allocate a meaningful amount to active management and alternative asset categories, which we believe offer better prospects for return and can bring a range of diversification benefits, including a degree of inflation protection. Asset diversification is also important as we see an increase in volatility, where markets might deliver good gains but will not move higher in a straight line. Since the road to recovery will be bumpy, we expect periods of correction and consolidation ahead.

Allocations to less liquid-asset categories such as private equity, venture capital, hedge funds and real estate should be considered, if deemed suitable and commensurate with risk appetite. Here we see opportunities to invest in what is likely to be an increased desire for real assets and an equally strong environment for companies offering new technologies and digital disruption. We think now is a particularly interesting time to increase exposure to venture capital strategies.

In this piece, we aim to explore these themes further by looking more closely at the following:

- Growth implications of our two-speed world as the US and China lead global GDP higher.
- The risk of inflation, using history as guide.
- Our resulting asset allocation implications and positioning.

### **Growth implications of the post-pandemic two-speed world; US and China lead global GDP higher**

The US and China are both expected to grow by 7-8% this year and emerge as clear post-pandemic winners. The US's recent progress on the vaccine, combined with both unprecedented fiscal and monetary accommodation and a new willingness to invest beyond the recovery, is setting the stage for a new normal in US economic growth. China's containment of the virus and vision for long-term growth will also spur significant investment. Both countries, in different ways, have come to embrace a new vision for post-pandemic growth.

Up until this point, fiscal expansion has backstopped entire sectors of each economy; monetary policy has provided further indispensable liquidity to limit economic fall-out and support a recovery. However, the US and China are now focused not on the sugar rush of subsidy and support, but on a new vision of investment-led growth. The requirement for investment is driven by needs to:

- Heal economies from the effects of Covid
- Raise living standards across the economy
- Achieve the goal of carbon neutrality
- Compete in a world requiring greater digital enablement

The pandemic has raised the urgency of these types of investment, which require a multi-year structural approach. Both the US and China understand this imperative; other nations will likely get there in time.

Sectors and companies leveraged to their respective strategic visions of priority could well be tomorrow's secular growth winners. Spending plans outlined below will spark greater recognition and debate on the role of government spending to increase global competitiveness.

## The US Plan

Barely had the ink dried on President Biden's \$1.9tn American Rescue Plan when he put forth perhaps the boldest fiscal stimulus package since Johnson's Great Society or FDR's New Deal. The American Jobs Plan in Biden's words is the first truly national effort aimed at "creating jobs, building a modern, sustainable infrastructure and delivering an equitable clean energy future". The \$2.3tn proposal to overhaul and upgrade the nation's infrastructure has lofty, multi-year ambitions to create the "most resilient, innovative economy in the world while creating the largest American jobs investment since the Second World War."

The spending proposals are targeted at building a greener, more advanced US economy:

- **Infrastructure:** rebuilding 20,000 miles of roads while repairing the 10 most economically important bridges in the country and eliminating lead pipes from the nation's water supplies.
- **Clean-energy investment:**
  - Rebuilding domestic auto-supply chains and infrastructure, from parts and materials to electric vehicle (EV) charging stations, positioning America to win the 21st-century electric and autonomous vehicle race.
  - Providing every American city with high-quality, zero-emissions public transportation options through flexible federal investments with strong labour protections.
  - Building clean, American-made electricity to achieve a carbon pollution-free power sector by 2035.
  - Upgrading building stock by funding direct cash rebates and low-cost financing to upgrade and electrify home appliances and install more efficient windows; the aim being to reduce residential energy bills and spur the construction of 1.5 million sustainable homes and housing units.
  - Investing in clean-energy technologies – including battery storage, negative-emissions technologies, the next generation of building materials, renewable hydrogen and advanced nuclear – and rapidly commercialising them, ensuring that these new technologies are made in America.
  - Creating jobs in climate-smart agriculture, resilience and conservation, while reducing toxic waste and preventing local environmental damage.
- **Digitalisation and innovation:**
  - Expanding broadband and wireless broadband via 5G to every American home, "recognising that millions of households without access to broadband are locked out of an economy that is increasingly reliant on virtual collaboration".
  - Increasing research and development (R&D) spend. The plan aims at the biggest increase in federal non-defence research and development spending on record.
  - \$300bn to boost and automate the US manufacturing sector, including \$50bn for semiconductor production and research.

The proposed spending would take place over eight years; Biden projects costs would be offset by increased corporate tax revenues raised over 15 years, particularly from multinationals that earn and book profits overseas in a new form of a global minimum tax. In Biden's economic forecast, taxes would more than offset spending in 15 years, leading to an eventual reduction of the budget deficit.

US Treasury secretary Janet Yellen called on corporate America to embrace what she called “mutually beneficial” tax increases, saying Biden’s \$2tn plan would deliver a 1.6% boost to gross domestic product by 2024.

*“America’s corporate tax system has long been broken, so too has been the way we think about corporate taxation: tax reform is not a zero-sum game, with corporations on one side and government on the other. There are policies that are mutually beneficial. Win-win is a very overused phrase, but we have a real one in front of us now.”*

**On the back of the \$5tn in stimulus already pumped into the US economy, this stimulus package alone is grounds for a strong recovery in 2021.**

But US growth is also likely to benefit from a cocktail of other catalysts:

- **Pent-up demand** as the US economy begins to re-open more fully. Strong consumption growth is likely to benefit from stimulus splurge, better job prospects, excess savings accumulated during lockdown (over \$2tn and counting, 10% of GDP) and wealth effects from strong stock market gains.
- **A housing boom.** House prices have been rising in every corner of the US, with the pace of new home sales to highs not seen for 14 years. In March 2021, the median home listing price reached an all-time high of \$370,000, up 15.6% compared to last year. A combination of heightened demand, in part due to the pandemic (buyers are looking for more space in a new world of flexible working), low inventories, millennial demand and record-low mortgage rates have supported a record boom in US housing.
- **Extremely low levels of interest rates** as the US Central Bank has promised to keep interest rates low until the Fed achieves its dual goals of full employment (with much more social equity focus) and inflation of greater than 2% on a sustained basis. The Fed has continued to say that rates will stay low until 2024 at the earliest.
- **An expected pick-up in investment spending** as companies benefit from better earnings and cash flows. Earnings estimates continue to move higher, with full-year 2021 earnings for the S&P 500 Index currently expected to be up +27.6% relative to 2020. In addition, large US companies are carrying a sizeable \$3tn cash cushion on balance sheets.
- And if history is any guide, **spending initiatives may be easier to garner approval than increases in taxation** to pay for them. Could we have the juice and not the tonic?

Taking these catalysts together, we think the US could see 7-8% growth in 2021 and above-average growth beyond. Indeed, the OECD has increased its global GDP forecast by 1% in 2021 based on anticipated incremental growth from the US as the world’s largest economy. **A growing economy with low interest rates can also help power dynamic growth from the private sector.** There are already plenty of examples of new emerging businesses in fintech, edtech, health tech and green tech powered by a cloud-based, more digitally oriented world, post pandemic, with greater use of data and artificial intelligence. Government investment would add greater fuel to the innovation fodder.

**If this next stimulus package is approved, the anticipated level of spending would end decades of stagnation in federal investment.** Government investment as a share of the economy would return to its highest levels, not seen since the 1960s. Cornerstone Macro argues that capital spending at just 13% of US GDP has the potential to double over the next few years. It sees a sustained US investment cycle that significantly boosts productivity:

*“If Biden gets even half what he has proposed, we expect US real capex to increase 12% year-on-year in 4Q of 2021. The US economy is starting a secular shift up in investment spend as a % GDP, with huge implications, for a healthy job market and productivity gains.”*

The scale of the plan underscores how fully Biden has embraced the opportunity to use federal spending to address longstanding social and economic challenges. Biden’s plan is intended to create millions of jobs while also positioning America to be able to compete with China. In his speech introducing the plan, Biden mentions China no less than 10 times. His point is clear:

*“The American Jobs Plan is not about short-term stimulus. It’s about making sure that America is positioned to compete for the next decade and for the generation ahead. We know that China and our other strategic competitors are already making major investments. It’s time for America to invest and lead the way again.”*

**The US has arguably suffered decades of domestic underinvestment due to 40 years of globalisation and shifting manufacturing and jobs abroad.** The trend started with Japan in the 1980s, the Pacific Rim Tigers in the 1990s and China in the 2000s. Biden aims to bring jobs back home, in the context of an ambitious sustainable competitiveness and green investment agenda.

However, success is far from guaranteed as Biden could fail to get major parts of the plan approved. He could also get his timing wrong, for instance increasing taxes before the infrastructure plan has a chance to positively impact growth. Bigger government spending is not always the panacea for efficient, long-term investment, as US capitalism has repeatedly shown. To be effective, it needs to be supported by public-private partnerships, which have the added benefit of increasing the investment discipline.

But for once, the US might be looking beyond the “here and now” to a longer-term strategic and industrial vision.

### **The China Plan:**

China has always taken a long-term approach to its strategic, multi-year investment ambitions. Indeed, weeks before the Biden stimulus announcements, China announced its 14th Five-Year Plan. In it, the nation’s leaders set an ambitious agenda to “promote high-quality development in all aspects of the economy, including the environment, urban renewal, people’s livelihoods and wellbeing, while realising our ambition to be a global leader in all things technology related”.

Technology lies at the heart of China’s vision for its future. The plan names seven “frontier” technology fields in which the country aims to cultivate leading domestic capabilities:

1. New Generation Artificial Intelligence
2. Quantum Information

3. Integrated Circuits (or Semiconductors)
4. Neuroscience and Brain-Inspired Research
5. Genetics and Biotechnology
6. Clinical Medicine and Health
7. Deep Sea, Deep Space and Polar Exploration

The plan also highlights China's industrial ambitions to strengthen its role as a manufacturing superpower, including robotics, autonomous vehicles, high-end medical devices and innovative medicines.

China's vision speaks to its so-called dual circulation strategy, which aims to promote a stronger domestic market ("internal circulation") while continuing to promote mutually beneficial external relations ("external circulation"). To some degree, this policy is a newly packaged version of its longstanding goal to reduce reliance on export-led development and rely more on the domestic cycle of innovation and consumption to drive economic growth.

For the first time, China has also committed to a goal of carbon neutrality by 2060. The country is already a leader in EV battery technology, and its market has seen the fastest growth in EVs over the past decade. UBS estimates that China's green ambitions could drive a twofold rise in solar instalments, 40% growth in wind instalments and a fivefold increase in EV production by 2025.

Like Biden's proposal, China's plan addresses green and digital urban renewal with plans for a further 100 million people in cities by 2025, supported by continued large-scale investments in energy-efficient buildings, broadband and 5G rollout.

**China's strategic vision based on technological leadership and supply-side resilience is advantaged in many ways:**

- R&D spending growth has been twice as fast as that of the US.
- China is already home to the largest stock of supercomputers and industrial robots.
- It already has leadership in many digital enabling technologies, with artificial intelligence and big data powering smarter infrastructure across the country.
- It controls 57% of the global e-commerce market and is a leader in the transition to cashless societies; today, Alipay and WeChat Pay claim over 500 million and 900 million users respectively.
- It has become the first large economy to introduce a digital currency, underscoring its position as the global leader in payments technology.

**Now, China's model has many drawbacks to a western eye, not least the government's heavy hand in the economy and society.** The country's track record when it comes to human rights, and its lack of transparency and alignment to global mores of fair competition and engagement, are also concerns. However, one can't help but recognise the power of this country in the years ahead.

For the first time, China's plan also chimes with the US's strategic ambitions, or perhaps competes with them. Both countries have prioritised innovation and clean energy. As previously stated, the battle lines for leadership in key technologies are likely to take shape over the next few years.

**Our strategy is to have investments and exposure to areas most likely to benefit from what could well be the largest combined investment spend that the world has seen since the Second World War.**

### **But what about the Inflation Genie?**

Over the past few weeks, ebullience over the prospect of a strong recovery fuelled by trillions of dollars in stimulus and investment has been met with equal caution and fear on the inflation side. Growth is good but too much growth can stoke supply-side constraints and rising prices. We have already seen signs of price increases in inflation numbers as global economies have begun to recover, with large parts of the commodity and food complex seeing higher prices since the lows of last year. Critical inputs such as silicon and semiconductors are already in short supply. Bond yields have moved higher across the developed world.

**The worry is most acute in the US as Biden's stimulus packages are being further fuelled by an accommodative Fed.** Powell has pledged to allow the economy to “run hot” until it truly achieves lasting inflation and has embraced a new form of maximum employment, taking into consideration a range of social indicators, including the racial unemployment divide. The Fed has continued to reiterate that it would continue to buy bonds until “substantial further progress” was made towards its goals, which it doesn't think is likely until early 2024.

**The Fed's policy is based on the view that while inflation will increase in 2021, the rise is likely to be transitory and controllable. For now, we agree.** The global economy is still operating below capacity, while there exists ample slack in labour markets and large parts of the global economy remain scarred from the effects of the Covid crisis. Increases in demand will be met with expansion in supply over time. Looking forward, large-scale investment spend of the sort contemplated by the US and China should bring significant productivity gains. Innovation, digitalisation and automation can combine to keep a lid on rising wages while lowering costs and creating efficiency gains, all of which remain disinflationary.

**And yet, we can't rule out the proverbial inflation genie's escape from the bottle.** The last time inflation reached runaway levels was in the 1970s. Too much fiscal stimulus and President Johnson's Great Society – exacerbated by spending associated with the Vietnam war, so-called guns and butter – led to a vicious spiral of wage increases and rising prices of crucial domestic supplies. The two oil shocks then caused growth to slow and inflation to soar. The result was stagflation, slowing growth and rising inflation ushering in a challenging decade for asset prices. For the holders of bonds, the 1970s was a decade of declining prices. Stocks did terribly, too. The price/earnings ratio collapsed from 24x earnings in 1966 to 8x in 1982.

**Could the world be on the cusp of something similar?**

**At the moment, even the smartest minds in global economics can't agree on the outlook for inflation.** A daily debate has been waging as the US economy nears reopening. In one corner, economists and politicians argue that they have learned lessons from the slow growth that followed the Great Recession, and that “going big” is better than “going small”. They posit that years of below-target price growth show the economy can run hotter than previously thought and fears of runaway inflation are overblown.

The other side, led by former US Treasury Secretary Larry Summers and others, argues that inflation overshoots can quickly morph into rampant price growth and that the Fed might lose its grip on inflation, plunging the country into a 1970s-like downturn. It claims that the lessons of the Great Recession are not as relevant as the lessons of the seventies Great Inflation.

### **But are inflation and rising interest rates always bad for stocks?**

Not necessarily. Bernstein research argues that since 1948, US stocks posted average quarterly returns of 2.7% when inflation was between 2% and 4%. Returns only fell below 1% when inflation exceeded 4%, which is well beyond the current five-year forward US inflation expectations of about 2.1%. Similarly, stocks have done well when interest rates have risen, when accompanied with better expectations for growth. Over 18 periods of rising US Treasury yields since 1971, for example, global stocks gained an average of 14% a year, according to Bernstein research. Rising rates typically do not hurt stock returns as long as they are accompanied by an acceleration of economic growth and corporate earnings. That is the potential scenario today.

### **Our Asset Allocation Conclusions**

We believe the world's two largest economies could experience a growth and investment boom over the next few years, which would have positive implications for the following:

- Global growth post 2021; this has the potential to be a multi-year expansionary cycle.
- Improvements in productivity, which should help limit the speed and degree of inflation.
- Digital demand as both the government and private sector invest in digital enablement at the same time, in a mutually reinforcing cycle.
- Sustainable technologies and clean-energy transition winners as the US and China (and other nations) invest to achieve carbon-neutrality objectives.

The world's two largest economies account for 40% of global gross domestic product. Strong investment-led growth in both economies will help lift the global tide of growth, though not all countries, sectors and companies will benefit to the same degree.

**The old investment adage in China was always to invest in a way that aligned with the government's strategic priorities. If Biden gets his way, we would say this applies to the US as well.**

### **In summary:**

- **2021 will remain a strong equity market environment**, with increased earnings and cash flow supporting markets and helping highly profitable and genuine growth stocks grow into more acceptable valuations.
- **Breadth will continue to increase** as companies across the world that are exposed to global growth and innovation do well. Increased market and sector participation will extend the bull market. Ample liquidity and a lack of real returns in bonds mean flows into equity (both public and private) are likely to continue.
- **Active management will benefit from differential returns**, as not all "boats will be lifted by the rising tide" of global growth. Sectors and companies leveraged to the strategic priorities of the US and China and the reopening of global economies, including European and Asian global

champions, will do well. Those still grappling with vaccine roll-out and a more tepid recovery may be permanently scarred post pandemic.

- **Real assets such as real estate (particularly residential) and commodities** linked to the rebuilding of infrastructure and housing stock should also do well. Investment in infrastructure and a greener urban environment are fundamentally positive for a range of industrial and precious metals. We intend to keep Gold and other forms of inflation protection as a core part of our portfolio strategy.
- **Private equity across strategies and geographies** will continue to be an important way to access secular growth themes early on, as new business models based on transformative technologies, increasing digitalisation and new sustainable technologies keep emerging. We are particularly positive on venture capital delivering access to this opportunity.
- **Fears of inflation and a normalisation of bond yields** to pre-pandemic levels will remain worry themes of this year and beyond. Investors will also fret about geopolitical concerns as the US and China flex their strategic ambitions in different ways. Markets will become more volatile as a result and we expect some nail-biting corrections along the way.
- **The US dollar and Chinese yuan might remain well-supported** if, as expected, both economies outperform their peers.

**In this two-speed world, we remain well positioned in the US and continue to increase our allocations to China.**

*In our view, China remains incredibly underinvested as an asset class. Globally, China accounts for about 18% of world market capitalisation and 30% of listed stocks, but only 2.5% of global fund allocations. This is a big anomaly. As the market continues to open up and China's vast potential is realised, we think this simply has to change.*

We believe flows of funds afford a terrific opportunity for family offices, which are not constrained by benchmarks, to get ahead of what we see as increasing allocations into China and the broader Asian region over the next five to ten years.

But we will also keep a watchful eye on inflation. Long-term wealth with a multi-generational mindset is all about driving returns above inflation.

*In the words of John Maynard Keynes: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."*

In general, the ownership of shares is good protection since corporate revenues and profits get a boost from more activity and pricing power. Real assets, either in physical or digital form, can also provide a store of value against rising inflation. We recommend remaining invested in line with client-specific risk and return objectives.

**In conclusion, the outlook is positive, but there are manifold risks along the way.**

Tolstoy once said:

*"All the variety of life is made up of light and shadow."*

The US and China might represent the light, but their respective policies and potential risk of inflation could also bring unforeseen shadows.

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