Antipodes

GLOBAL EQUITIES IN 2022 & BEYOND

Why pragmatic value matters

The pace of economic growth is slowing, but from an unsustainably high base.

The sharp rebound in economic activity over the last year has been driven by the extraordinary amount of post-pandemic stimulus. The pace of economic growth is now slowing, and that's because stimulus has faded.

We've seen lockdown-related overspending on goods, which will normalise with reopening, but spending in the services sector is still yet to fully normalise. It's also worth bearing in mind that softer manufacturing activity is related to constraints along the entire supply chain – from raw materials all the way through to transport – resulting in an inability to meet demand. Record low inventories are being reported broadly across most industries.

Assuming no adverse COVID-19 developments, and supply chain constraints are ultimately alleviated, our base case is that economic growth can remain relatively resilient given the level of pent-up savings in the system and strength of household balance sheets, and emerging capex cycles. Any persistent slowdown in manufacturing activity, however, and the extent to which it is supply or demand related, must be closely monitored.

Whilst the personal savings rate in the US has returned to trend levels, excess savings from stimulus and underspending remains steady at $2.7t, or just shy of 20% of current household spending, and wages are rising. This is material firepower that can be deployed to prevent a hard landing.

If just two-thirds of this excess savings is spent over the next three years, it would add two percentage points to trend growth.

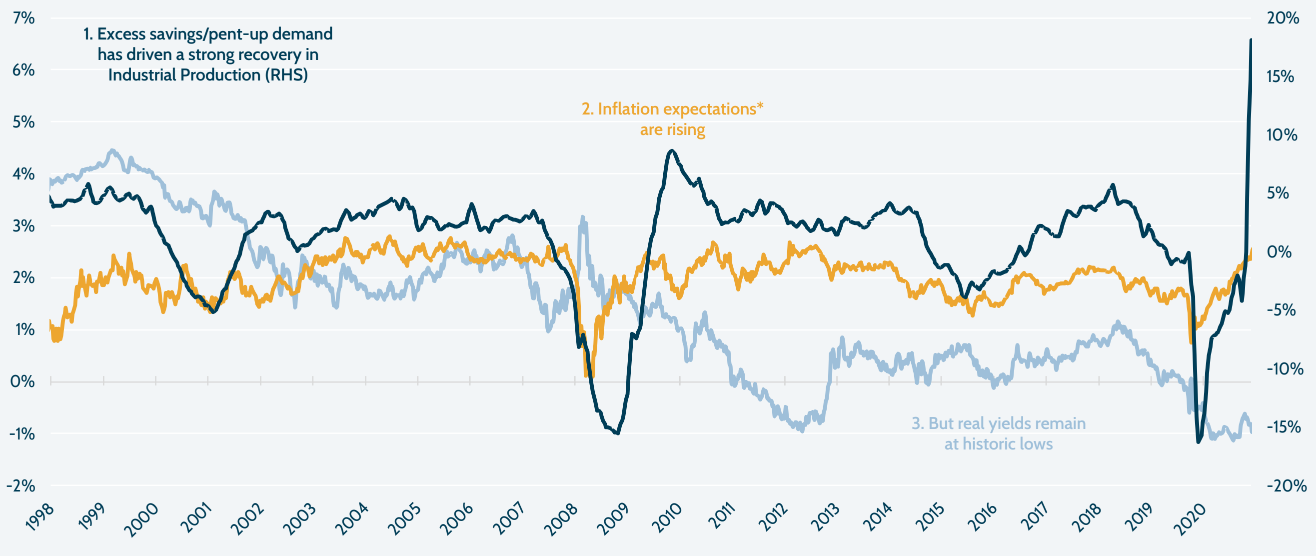
Further, a higher weighting to the services sector could see Europe soon hit a sweet spot in reopening as cross border travel resumes. Tourism accounts for 10% of GDP in Europe, compared to 3% in the US.

Even with a slower pace of economic growth, yields appear too low relative to the outlook for activity and inflation. There is a disconnect between the bond market and what we can observe in the real economy (Figure 1).

Additionally, the US Federal Reserve (the Fed) has begun tapering its monthly pace of Treasury purchases and will no longer buy new issuance of Treasury debt after June 2022. Removing a price agnostic buyer like the Fed can also put pressure on yields to rise to find new incremental buyers to fund ongoing deficits. The Fed also appears open to modest rate hikes.

Figure 1

US 10Y REAL YIELDS, INFLATION EXPECTATIONS AND INDUSTRIAL PRODUCTION (YOY)



*Inflation expectations measured by subtracting the 10Y inflation protected yield from nominal yields.
Source: Bloomberg

On the balance of probabilities, the direction of yields is more likely to be up rather than down.

The question is what is already priced into equities today.

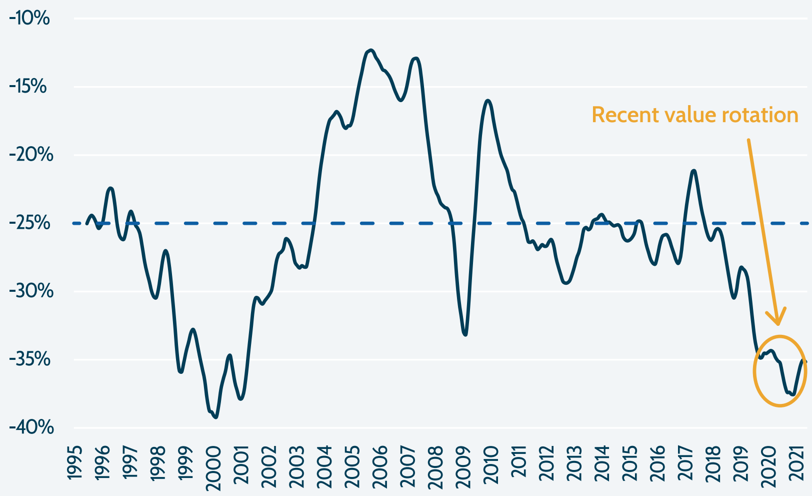
High multiple – or long duration – assets have disproportionately benefited from the collapse in discount rates which have materially increased the value of cash flows further in the future. As a result, Value's discount to Growth has rarely been as attractive as it is today (Figure 2).

Any move higher in yields will be a headwind for weaker businesses, especially if the starting multiple is high.

The risk to this thesis is disappointment in economic growth - that activity in the near-term moderates faster than expected before investment-led growth gains traction. We will delve deeper into this risk, and the potential of an inflation shock, later in this paper.

Figure 2

GLOBAL EQUITIES, SECTOR NEUTRAL, COMPOSITE VALUATION*



As at Jun 2021

Source: FactSet, Antipodes

* High to low multiple quintiles are determined by the Antipodes Value score, a composite of point-in-time multiples and world relative z-scores

** Forward PE, cyclically adjusted PE, cyclically adjusted EV/EBIT, EV/Sales and EV/Operating Capital Employed (including goodwill) for industrials, with EV based measures replaced with PB and cyclically adjusted P/Pre-provision profits for financials.

INFLATION. IT'S HAPPENING.

Pandemic related pressures in supply chains will subside as economies fully reopen and supply chains normalise, but this can be offset by pressure in wages, rent and energy prices. Even with growth in economic activity slowing, we don't see core inflation in the US peaking until the end of next year.

In the US, wages are currently rising at 5% p.a. versus historical levels of 3%, despite the current slack in the labour market. This may be exacerbated by a normalisation in consumer spending in the labour-intensive services sector.

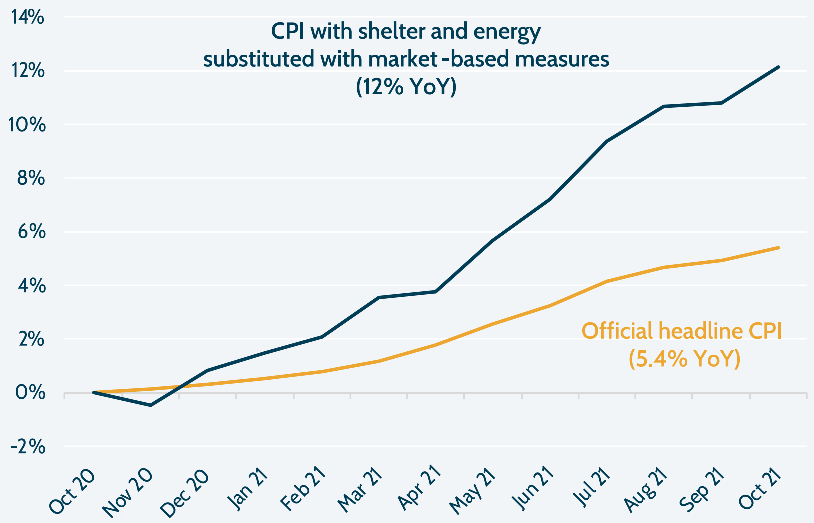
House prices in the US are rising at the fastest pace in 15 years which feeds into rents with a lag.

Elevated energy prices are another pressure point. Europe is facing a shortage of gas due to a strong rebound in economic activity coupled with supply issues. European power and global LNG prices are likely to remain elevated due to a fundamental need for investment. Consequently, there's been a shift to burning oil in Asia, which brings another conundrum in energy markets – that the gas rally is fuelling an oil rally. Given an abundance of gas in the US, gas production will increase over time as will exports due to greater demand for gas globally as a transition fuel and relatively low gas prices in the US compared to Europe.

On our analysis, adjusting the rental and energy components of CPI to capture underlying market moves more closely, September's headline CPI would increase from 5.4% to 12.1% (Figure 3). Whilst energy doesn't directly impact core CPI, it provides a sense of the inflationary pressures that are building and have the potential to feed through in a meaningful manner.

Figure 3

US CPI NOT EXPRESSING DEGREE TO WHICH RENTAL AND ENERGY COSTS ARE RISING



Source: BLS, Zillow, Bloomberg, Antipodes

Our view remains that inflation can remain sticky over the short-term and above average going forward.

Over the longer-term, the evolution in China's economy can reverse a major deflationary trend. China's advantage in low-cost manufacturing labour has narrowed with the fruits of success – wages have risen. China is slowly moving on from its status as global factory to becoming a consumption driven economy. China is also prioritising emissions reduction, particularly in emission intensive sectors. Hence, in sectors where China represents a large proportion of global supply such as steel, aluminium, PVC and urea, we would expect prices to remain elevated even in a weaker demand environment.

Further, aging populations lead to a growing consumption-income gap that is increasingly funded by already indebted governments. For countries with a weak external position this will ultimately prove inflationary.

Finally, in response to this period of exceptionally loose monetary and fiscal policy, private sector demand may rebound to a level which sees credit growth accelerate, the money multiplier rise and with it the likelihood of structurally higher inflation. How high would be a function of the productivity offsets from higher levels of investment and technological innovation.

CHINA; WHERE TO FROM HERE

China emerged from COVID-19 stronger than Western economies and used the sharp rebound to tighten policy and initiate reform. As a result, China is slowing at a faster pace relative to the West.

Given substantial capacity to loosen, our view is China will re-stimulate once the downside risks from reform, especially in the property sector, become intolerable. It will pay to monitor property policy developments closely.

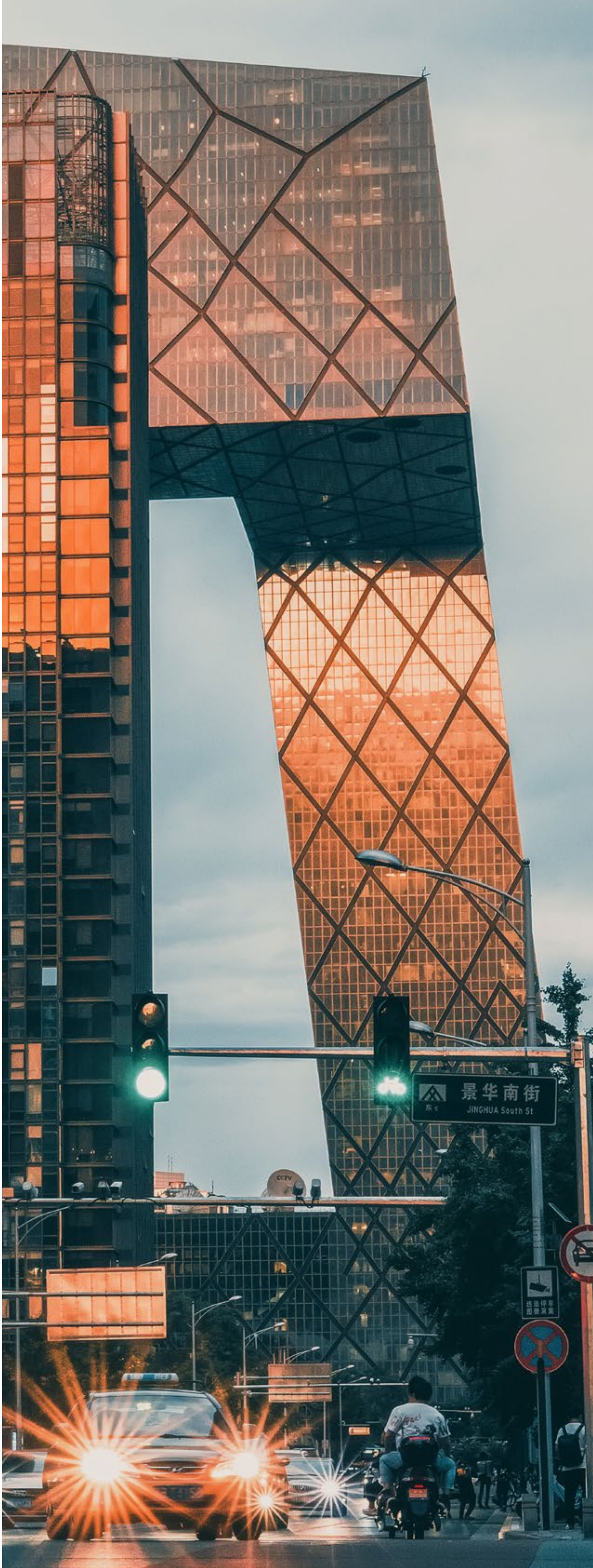
Evergrande's debt, combined with that of other risky property developers, accounts for around 2% of system

loans. Under our extreme stress test, banks' Tier 1 capital ratio would remain well above the minimum 7.5%, meaning there's plenty of capital supporting the system. The key issue is whether an Evergrande (et al) default seizes up financing for other property developers. This would have material implications for China's economic growth given residential property development accounts for 10% of GDP. A 20% fall in housing starts could shave up to two percentage points from growth and weaker housing prices would feed through to consumption via the wealth effect.

Policy makers in China appreciate that to accelerate the transition to a consumption and services driven economy – and lift the quality of economic growth – requires a vibrant private/technology sector and that high-profile internet businesses are an important part of this. It also requires household spending to grow at a faster pace than incomes. China's extraordinarily high gross savings rate, at nearly 45% of disposable income and almost double that of the Western world, needs to be run down. The broad goal of policy makers is to incentivise consumption today rather than saving for the future via improving the social safety net through affordable housing, education and healthcare.

Recent policies around anti-competitive behaviour and data security are relatively rational and consistent with policies elsewhere in the world. With changes in the regulatory backdrop now well-progressed, and Chinese equities valued at a 35% discount to US equities – the largest discount since the Asian crisis – investors will start to re-focus on long-term opportunities.

On our analysis, even under a policy of "common prosperity", by 2030 China's "premium" consumer household with a developed world average income will grow by ~70m and trading-up "aspirational" households by ~100m. Concerns around regulation have provided an opportunity to position for this mega-trend at very attractive valuations. We favour resilient opportunities across premium brands, digital advertising/services, penetration of e-commerce into lower tier cities and modernisation of the fresh food and restaurant channel.



NEW INVESTMENT CYCLES EVEN OUT THE PLAYING FIELD

Over the longer-term, our view remains that Western policy makers will be reluctant to shift to austerity too quickly and attitudes towards fiscal stimulus have fundamentally shifted. Investment cycles around decarbonisation, 5G and high-speed broadband adoption, and physical and social infrastructure generate economic activity and employment. As an example, decarbonisation is a central pillar of policy across Europe, China and the US. On our analysis we could see incremental investment of 2% p.a. (Europe/US) to 8% p.a. (China) over many decades as countries invest to achieve decarbonisation goals. And there is likely to be a multiplier on this spend as decarbonisation is relatively labour intensive.

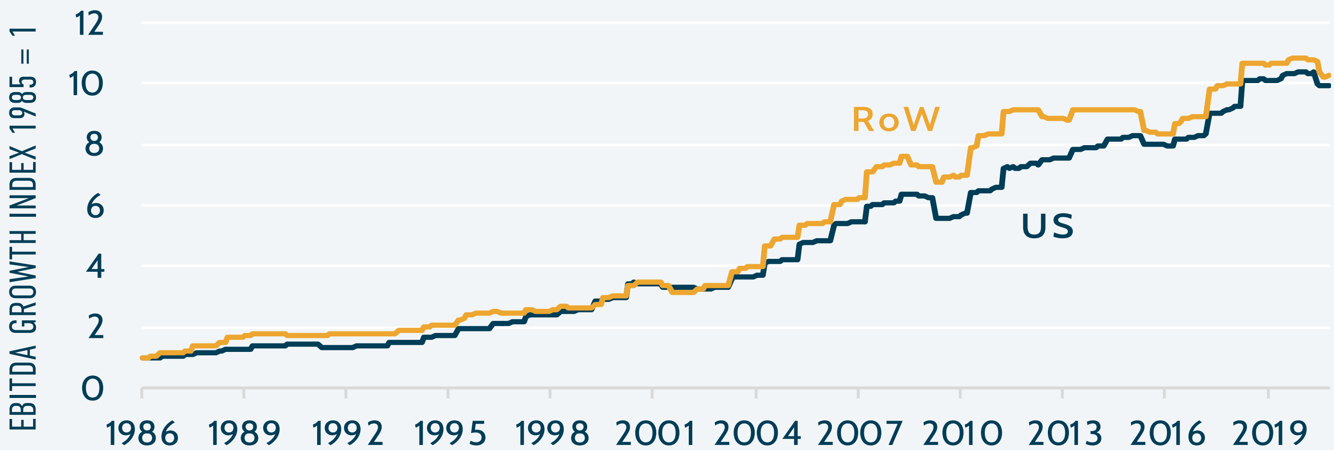
New investment cycles can lead to a shift away from viewing the world as a permanently low growth, low rate environment. New winners will emerge which can further fuel the rotation in equity market preferences.

New investment trends can also tighten the extreme valuation dispersion between US equities and the rest of the world. US equities are as expensive as they have ever been in an absolute and relative sense, valued at a 65% premium relative to the rest of the world. This is despite very similar earnings growth since 1985.

Figures 4 and 5

US* PRICED AT A 65% PREMIUM TO THE REST OF THE WORLD, LARGEST ON RECORD...

... DESPITE SIMILAR THROUGH-TIME EBITDA GROWTH



*Cyclically adjusted EV/EBITDA
Source: FactSet, Antipodes

This premium has been driven by outsized fiscal stimulus in the US and exposure to recent secular trends around software and the internet, which have been led by US companies. New investment cycles around decarbonisation and infrastructure benefit companies globally, and the rest of the world is not priced for success.

The global benchmark, with 60% exposure to US equities, is unlikely to reflect the best opportunities today.

Our portfolio remains underweight the US and overweight Europe and Asia on valuation grounds.

TAIL RISKS

Against a once in a generation policy backdrop, the range of outcomes remains wide. We see two key tail risks that should be monitored closely: an economic growth shock and an inflation shock.

An economic growth shock could come from a hard landing in China from policy tightening, which would coincide with a slowdown in the West as it passes the peak of the stimulus led rebound. Fed tightening into slowing growth could compound the problem. This would be a challenging environment for cyclicals and weaker companies or "value traps".

The second risk is an inflation shock from structurally higher and more volatile inflation led by the US. Discount rates would rise, and more quantitative easing in response is likely to be counterproductive. This would be a challenging environment for higher multiple stocks and weaker companies or "growth traps".

The combination of both an economic growth shock and an inflation shock – a stagflation scenario – would be a difficult environment for equities generally as it could lead to a highly correlated drawdown in markets. US equities, however, would be particularly vulnerable given elevated starting multiples.

RESILIENT MARKET LEADERS

Extremely high multiple dispersion is providing pragmatic value opportunities across the growth spectrum. To protect against tail-risks, regardless of whether the business has a cyclical or secular growth profile, we focus on resilient market leaders that can take profitable market share against a backdrop of higher inflation.

In the GDP-like growth part of the portfolio, we're overweight European/global cyclicals that will perform well in reopening (e.g. retail banks, travel, autos) and US natural gas as a transition fuel given severe supply rationing.

The next level of the portfolio could be broadly characterised as cyclicals that are transitioning to secular growth as the enablers of the emerging infrastructure (tech and traditional) and decarbonisation super-cycles.

And lastly, we have exposure to existing secular growers across digital advertising, omni channel retail and software/cloud infrastructure in developed and emerging markets. These are companies that are cheap relative to their growth profile and very cheap relative to smaller, single featured peers.

The Global Fund, with its additional emphasis on capital protection, looks for idiosyncratic shorts and attractively priced portfolio insurance to provide a further hedge against tail risks.

ANTIPODES PARTNERS

November 2021