Sanctum View

April 12, 2021

Time for Value as Growth and Inflation Arrives

- **Data to show strong growth in the US and China**
- **US headline inflation due to rise at least 100bps**
- **Value stocks to benefit from stronger nominal GDP growth**
- **Dollar's rise pauses and is still way off where it started last year**
- **The shift to ESG investments gains momentum**
- **Regulatory change around UCITS fund ESG credentials well-intentioned but messy**

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This week's data releases of US and China March industrial production and retail sales data will give us a good gauge of the current strength of growth in the global economy. Economists are relatively upbeat about both countries, although it is evident that the US will need to pick up the growth baton from a Chinese economy that provided the most robust economic performance of any of the major economies. China's authorities are looking to improve the quality of growth and rebalance away from the focus on cheap credit. Economists expect US retail sales growth of around 7.5% month-on-month for March and industrial production growth of +2.5% month-on-month.

China is due to report the highest ever level of quarterly GDP growth. The market expects GDP growth of +18.5% year-on-year. Retail sales +28% year-on-year and industrial production of +18% year-on-year will again emphasise the degree of economic repair over the past year. Trade numbers are also due, showing that China sees a substantial benefit from the global recovery underway. Economists expect exports to be up 38% year-on-year.

The other key data point of the week is the US inflation data. We expect some significant jumps in headline inflation from March forward due to the comparisons with a very weak COVID impacted late first/second quarter. Indicators of US inflation pressures have been strong even before the statistical jump expected through the next three months. In February, 80% of the Consumer Price Inflation basket components saw inflation. The latest industrial surveys from both the manufacturing and services sectors also showed very strong pipeline inflation. The market expects the headline rate to rise from 1.7% to 2.7%, with core inflation better behaved with a rise from 1.3% to 1.5%.

We continue to believe the bias of risk in global inflation is to the upside in the coming year. Economists struggle to make confidence judgements when there are so many shifting variables. However, the scale of government spending and the degree of pent-up demand in the global economy could converge to bring a surge of growth that sends inflation spiralling higher. Supply lines still seem disrupted, pipeline inflation is prevalent in many commodities, and consumers may be more willing than before to pay up to consume. Add to that the fact that inventory to sales ratios globally are low. When companies are running low inventories and see a surge in demand, higher prices are very likely.

Equities have maintained their strength so far in the second quarter, with both US and eurozone equities at new highs. We continue to believe that value stocks offer a better way of accessing future equity market performance. The value stocks versus growth stocks trade still seems valid given we have only just started to unravel ten years of underperformance. Higher inflation plays into the hands of value stocks, given that their profitability is more dependent on nominal GDP growth.

Chart 1: In the Very Early Days of the Value Sector's Recovery

MSCI Value Index versus MSCI Global Index

Source: Bloomberg

There was a lot of investor pain and worry about the US dollar's strength in the first quarter. In truth, it was exceptional. However, it followed a very marked poor performance by the US dollar through much of 2020. We do not expect the same pace of dollar appreciation to continue, particularly given the Federal Reserve's very emphatic language that they wish to maintain interest rates close to zero for some considerable time to come. Also, last week's slide in US 10-year Treasury yields took some of the wind out of the sails of the dollar. The trade-weighted index hit a two-week low.

Chart 2: US dollar Trade Weighted index recovering off the floor of last year's weakness

Source: Bloomberg

Investors looking to ESG for future investment opportunity will find both validation and confusion from the news flow. For validation, we note the increasing number of institutional investors adopting an ESG framework for their investments. The confusion comes from Europe, where the mutual fund regulatory changes on ESG disclosure just implemented are well-intentioned but could prove very messy in the near term.

Validation for ESG investing from institutional investors.

We note the dramatic increase in pressure on the fund management industry to incorporate ESG. In the United States, the University of Pennsylvania endowment fund with a value of $14.9 billion was the latest institutional investor to set the goal of eliminating net greenhouse gas emissions from its investment portfolio by 2050. Several University endowment funds have adopted such a target in the past 12 months, including Harvard, Stanford and the University of Oxford. Peer pressure is telling.

European ESG regulations well-intentioned but confusing for investors

For anyone holding a UCITS regulated mutual fund, the recently implemented ESG disclosure framework is well-intentioned but potentially very confusing.

At the regulatory level, the EU's introduction in March of a framework for 'sustainability risk disclosures' rather took the fund management industry by surprise, given that many institutions felt that the regulations would be delayed. Fund managers of European regulated mutual funds are now required to classify their mutual funds into one of three buckets:

Article 6 funds are funds that are not promoted as having ESG factors or objectives,

Article 8 funds are those that promote environmental or sustainable characteristics but do not have them as the overarching objective

Article 9 funds are those that specifically have sustainable goals as their objective.

Asset managers are now scrambling to classify their funds and to provide the disclosures required by the regulator.

For anyone investing in UCITS mutual funds, this might all seem somewhat confusing, at least in the near term. Some asset managers have already decided to classify as much as 90% of their fund range as article 8 and 9. Other managers have classified only 5% of their fund range. Investors cannot be sure that asset managers have used the same methodology to classify their funds. Investors holding funds classified as Article 6 funds might worry that the fund could see significant outflows as more investors put their money behind ESG compliant investments.

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