Revisiting our Chernobyl analogy in light of soaring inflation

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Back in 2020, when the European forward inflation expectations were around 1%, we wrote a blog asking, "What can we learn from Chernobyl?"

At that time, we tried to explain something complicated – inflation risk – with an analogy to something even more complicated: nuclear physics. Our observation, sparked by the HBO drama series 'Chernobyl', was that the disaster was caused by the reactor cooling too quickly and the subsequent actions taken to re-heat it.

In the panic to create heat, the plant engineers removed the coolants (water and boron rods) to a point that there was nothing protecting against the opposite action: too much heat. So, as heat started to rebuild, it became uncontrollable with devastating effects.

The return of inflation

Our point was that in terms of inflation, policymakers were at risk of making the same mistake as the engineers. So focused were they, and the financial markets, on 'no inflation' that we had all but forgotten the risk (and pain) of the opposite: inflation.

The key 'protection' against inflation is interest rates. And it was clear we'd removed all that protection by late 2020, when Europe's negative-yielding debt pool made up as much as three-quarters of the sovereign debt market.[1] Lenders were essentially paying governments to borrow their money.

Highlighting inflation risk back in June 2020 now looks prescient. However, the point we were making then wasn't that inflation would become rampant – more that there was a risk it might. If there was an inflationary spark, then the removal of counter controls meant it could become entrenched with damaging effects on economies and asset prices.

Within equities, we believed it would affect the type of equity that was beneficial to own. Short-duration equities (Value) would dethrone their long-duration counterparts (Quality/Growth). As we were aware of these risks over the past two years, we've seen our portfolios benefit against those with a historic growth bias.

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> **In the early stages of a new secular paradigm...most are conditioned to hear only the short-term noise they have been conditioned to respond to by the prior existing secular condition...**
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> **– Bob Farrell**

[1]Source: Reuters as at 3 October 2022. 'Euro zone's negative-yielding debt pile has almost disappeared' by Dhara Ranasinghe.

What's happened

As Figure 1 illustrates, inflation is back with a vengeance today, and gone is any rhetoric of 'transience'. Much like the engineers in Chernobyl's control room, the problem policymakers need to solve has moved from 'too cool' to 'too hot'. Central bankers are collectively pressing their AZ-5 buttons (the Chernobyl button that slammed all the boron rods back into the reactor at once).

But this is where the analogy ends. Chernobyl's boron rods were carbon-tipped, and with carbon serving as a catalyst in nuclear fusion, this meant their reintroduction caused yet more heat and hence disaster. Rate hikes are unlikely to speed up inflation. However, there are still considerable risks to consider, as we move from a world of inflation below the 2% target (as set by many central banks) to one above target inflation.

Figure 1: Inflation has returned to the Eurozone

Source: Eurostat, Factset as at 30 September 2022.

As recently as January 2022, the ECB deposit rate was still -50bps. As we know, the current rate (post the December meeting) is 2.0% with further hikes expected. Perhaps more remarkable is how forward expectations have changed. In January, expectations for European rates for 2025 were still 0%. Those expectations have shifted to around 2.4% today.

It was the realisation inflation wasn't transitory that has triggered this change, heavily influencing factor performance. Growth stocks in particular, where a significant part of valuation is based on future earnings discounted back, have been significantly de-rated.

What's next?

The key question from here is: how long do central bankers keep their fingers on the AZ-5 buttons? Where do financial conditions need to get to before they achieve their goal and inflation abates?

These are tough questions to answer – not least because inflation is a complex animal. To keep things simple, let's think about core inflation as driven by three equal components: goods, services and housing.

We know that the inflation of goods was the spark that ignited the inflationary trend we're in right now. Covid-19 curtailed supply, and when demand rebounded faster than supply, the disequilibrium sent prices up. This felt transitory, but the difference between transitory and entrenched inflation is time.

While supply chains were plagued by friction, Western economies began to unlock. Fuelled by savings from the pandemic, consumer demand for services swiftly picked up. The service sector is labour-intensive, and with labour unusually scarce, wages moved higher. It's wage inflation that's key – when wages move up more than target inflation, then that inflation is no longer transitory. Housing is more of a lagging indicator. But the combination of low rates and an abundance of savings, as well as lifestyle choices, inevitably led to house prices rising, leaving a long positive inflationary shadow.

Some of these frictions are abating, and financial conditions are tightening, so it's logical to assume inflation will ease. That's why commentators are writing about central banks 'pivoting' or moving from hawkish (raising rates) to dovish (cutting rates) into 2023. The European

5Y5Y inflation swap rate, a proxy for inflation expectations, is 2.3% today – up from 1% in June 2020).[2]

But herein lies the rub. How does inflation get back to 2.3% – only marginally ahead of target? Our view is that the market is right, and that headline and core inflation will mechanically roll over from current highs, but that's different to it returning to near 2%.

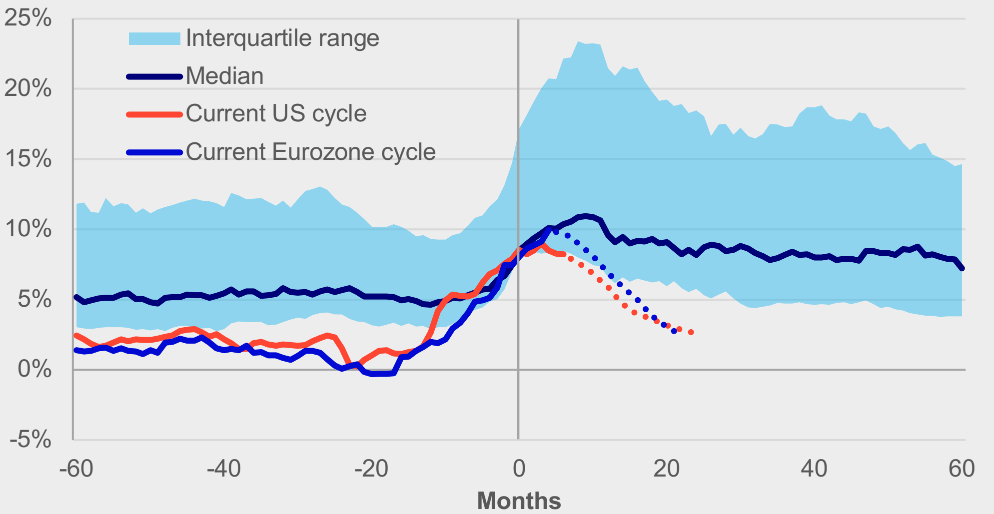
Looking ahead, our fear is that inflation will remain stubbornly ahead of target. Partly because low unemployment and wage momentum is making it sticky. Also, inflation becomes self-fulfilling: higher inflation today breeds higher inflation tomorrow.

While we've seen the peak inflationary quake, the aftershocks are still to follow. Food producers, for example, will have hedged 2022 input costs. As those hedges now roll over for 2023, these companies need to price up again.

Likewise, industrial companies or airlines, which typically hedge energy costs 12 months ahead, are only now seeing the impact of the inflationary pressures on their gross margins, and this will need to be compensated via higher prices. Figure 2 helps illustrate this view: the inflation tide is typically slow to recede and far slower than current expectations appear to be.

Because of these challenges, we think it unlikely that policy setters, having removed all the inflationary protection, will be able to perfectly land inflation back to target. This leads to two policy risks: central banks will either achieve Volker dogma and raise to the point of slowing the economy hard enough, or they'll pivot short term (which Volker did in his first attempt to reduce inflation – to disastrous effects) and we get a second leg of inflation and an even harder landing follows.

Figure 2: Is the consensus expectation of falling inflation rates too optimistic?



Source: GFD, Bloomberg, Deutsche Bank as at 31 December 2019. Data since 1970 (126 observations) with current US/EU consensus included. Dots = Bloomberg consensus.

What does this mean for European Equities?

First impressions might be that this is all bad news, and that now is the time to baton down the hatches and wait for better times. That's understandable, very consensual – and therefore almost certainly wrong on a forward-looking basis. We believe the consensual cautiousness is manifesting too heavily in recession fears and not focusing enough on the multiple risk that still exists in the market.

The market is typically fast to price economic cycles – participants track quarterly reporting momentum, inventory data, book to bill ratios. Likewise, most participants remember the economic slowdown caused by the Global Financial Crisis (GFC) and even Covid-19. With these tools and experience, the market prices cyclical risk efficiently. In our view, this means that much of the cyclical parts of the European market are already priced for recession.

[2] 5y5y= the average inflation rate over a 5-year period starting in five years time.

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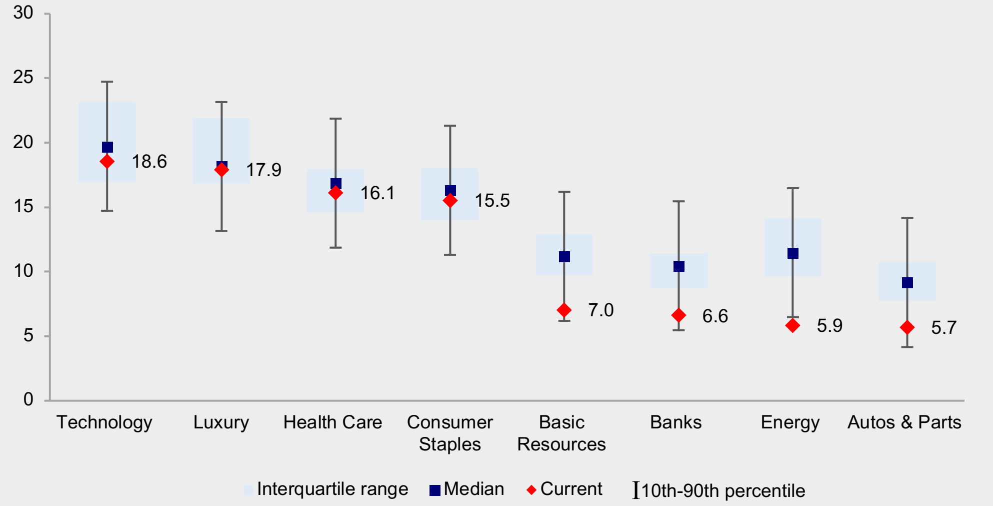
Moreover, in a shift of secular or long-term significance, the markets will be adapting to a new set of rules while most market participants will be still playing by the old rules.

– Bob Farrell

Figure 3: Value sectors trade on substantial discounts to their longer-term averages, whereas growth sectors remain on a large premium



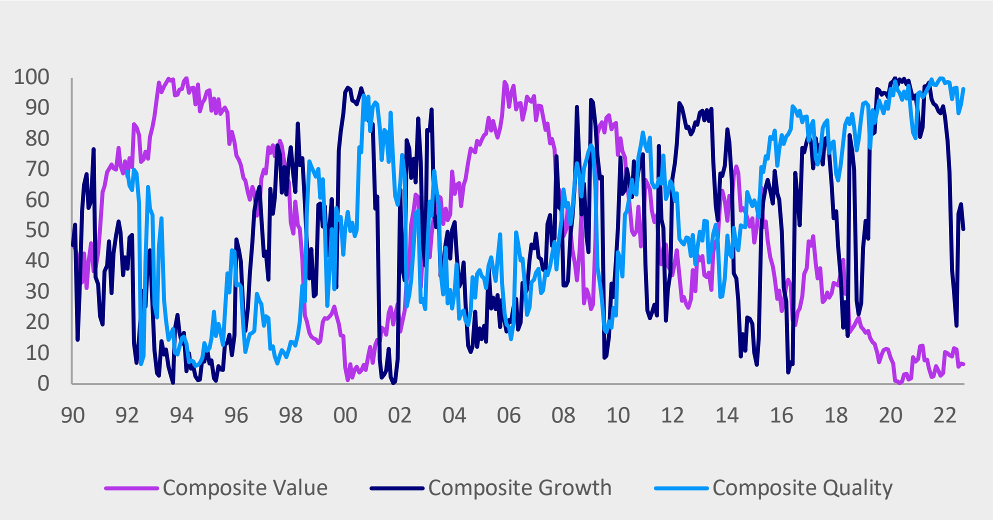
Source: Goldman Sachs as at 28 October 2022.

Where the mis-priced risk still lies, we believe, is in the Quality factor. Stocks in this factor category are still trading at near all-time highs. We believe it’s this risk that a more inflationary world, with increasingly big governments, isolationism, and more policy volatility that are being priced incorrectly.

These equities have downside risk to their trading multiples beyond a company’s control. Put differently, investor’s returns are negatively skewed: if companies continue to perform operationally, they are still at risk of de-rating. Meanwhile, if the new regime, including more nominal growth, impedes them operationally (relative or absolute), then they could de-rate further still.

High headline return on capital ratios will not be protection. Unlike cyclical risk, this risk isn’t yet discounted because it’s new and it doesn’t have obvious KPIs. We’ve not seen this risk since before the Great Moderation – a regime which began in the 1980s. We believe the market is conditioned to the old rules, even though there has been a secular shift. It’s this risk we continue to avoid within our portfolios.

Figure 4: Valuation of percentile factors



Source: Morgan Stanley as at 30 September 2022. **Composite Value** as calculated by Morgan Stanley: A composite score is generated from the equal weighted average of the 12-M Fwd P/E, Price-to-Book and the Total Yield (Dividend yield plus Net Buyback Yield) for all companies in the MSCI Europe. **Composite Growth** as calculated by Morgan Stanley: A composite score from equal weighted average of long term EPS growth, yoy Earnings growth and Internal growth (retention rate times ROE). **Composite Quality** as calculated by Morgan Stanley: A composite score from the equal weighted average of Return on Equity, EBITDA margin, Debt to Equity, Tax-to-pretax Income. **These scores are then grouped into quintiles – Q1 is the cheapest and Q5 the most expensive**. The average median PE and P/B of each quintile is then calculated and compared to each other. Universe is MSCI Europe.

The shifting regime that's a risk to Quality, is likewise a potential positive for cyclicality. Europe's biggest threat today is energy security. We expect, when the short-term winter crisis is behind us, that European policy will shift from gas storage to energy security. We expect to see more incentives to reduce consumption, upgrade incumbent infrastructure and step-up the build out of alternative energy supply. All these actions, combined with more nominal growth, are good for domestic European capex plays. These are currently amongst the cheapest equities in the region.

Our portfolios are not purely cyclical bets. We have defensive stocks making up a meaningful share of our funds. Companies within Pharmaceuticals, Telecommunications, Insurance and Food Retail, which are acyclical, yet equally are not at risk from the inflationary risk to valuations.

We believe our European equity portfolios are well-positioned from a top-down perspective to take advantage of the upside risks. At the same time, we're avoiding the new down-side risk that persistent inflation has created. From a bottom-up perspective, we continue to invest based on our philosophy to exploit mis-priced transition, a source of proven alpha. As the market transitions to the new rules of engagement – that of bigger government, more inflation and more volatility – investors should expect to see a great share of performance coming from alpha as opposed to market beta. We feel our portfolios are well placed to capitalise as the new regime continues to emerge and take hold.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Important information