POLAR CAPITAL

Polar Capital Global Convertible Team

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What is driving inflation?

Inflation has been low for a generation. Since the hyperinflation of the 1970s was quashed, the world has enjoyed muted inflation in an almost uninterrupted fashion. Anyone born in the developed world since the early 1970s has grown up knowing only stable prices and, indeed, since the global financial crisis (GFC) deflation has been considered a larger risk than inflation. That may now be changing.

In the US, Producer Price Inflation (PPI) in Q1 was at its highest level in 40 years and Consumer Price Inflation (CPI) was at its highest level in a decade while mentions of "inflation" during US earnings calls have more than tripled year-on-year[1].

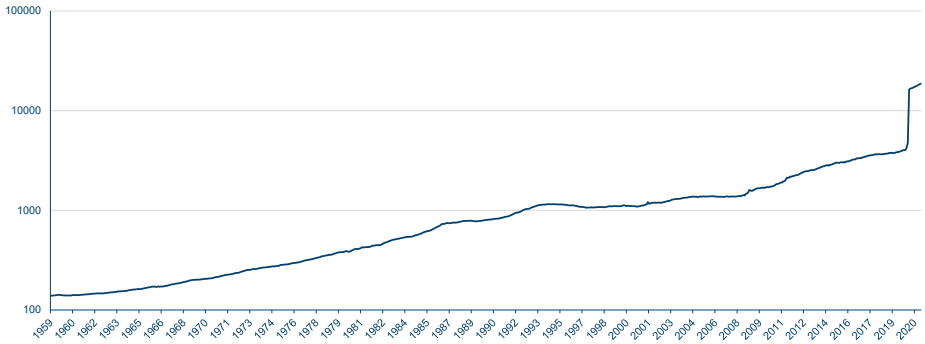
Given this, and the amount of investor interest we have seen on the topic, we thought it would be useful to explore the fundamentals of what we believe are the underlying drivers of inflationary risks and the ways in which these are and are not relevant for asset pricing. Rather than a formal economic analysis, what we present below represents our opinion of the path of causality that we believe best explains the current situation.

It all starts with money

Milton Friedman, the noted monetarist, famously declared: "Inflation is always and everywhere a monetary phenomenon".

In that context, global money supply growth is highly disconcerting. Below, we show the US Money Supply (M1) going back to 1959 which we depict logarithmically in order to highlight the rate of growth.

Money Supply (M1) Growth: 1959-Present



Source: Bloomberg.

As it clearly demonstrates, the rate of increase that was created by the COVID-19 pandemic policy response is unprecedented and of a vastly different magnitude than anything which has occurred previously. Between February 2020 and 2021, M1 (a broad measure of liquid cash and near cash) grew by over $14trn, or approximately 70% of US GDP in just a single year[2].

While this kind of growth does not necessarily cause inflation by itself, as Friedman notes it creates a fertile environment for it – and 70% growth in a single year is especially fertile.

1. Source: US Bureau of Labor Statistics, MarketWatch. 2. Source: Federal Reserve Bank of St Louis; Bloomberg. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital. Eurohedge Absolute UCITS Awards 2018. ©2021 Morningstar. All Rights Reserved. Rating representative of the USD I Dist Share Class, as at 28/02/2021. Ratings may vary between share classes. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. For more detailed information about the Morningstar Rating or Morningstar Analyst rating, including its methodology, please go to: http://corporate1.morningstar.com/AnalystRating/. All ratings and awards refer to the Polar Capital Global Convertible Fund.

Awards & ratings

Where did all the money go?

A common criticism lodged against monetarist arguments is that, despite the volume of monetary easing after the GFC, inflation remained subdued for over a decade at generational lows. So, what is different this time? The answer lies in where all the newly created money went.

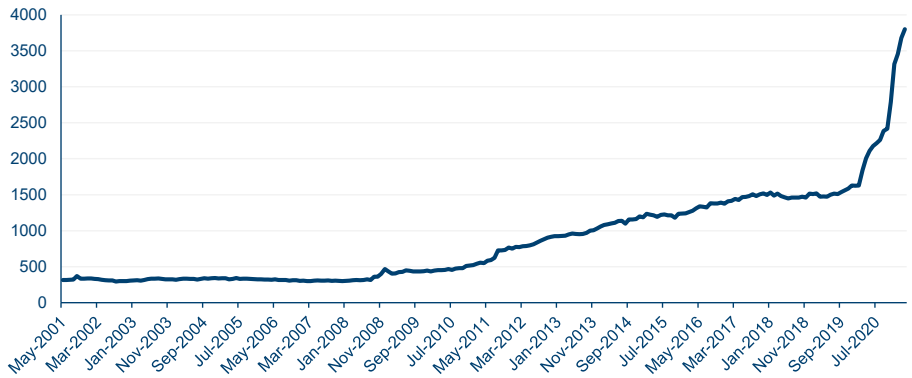
"Over the past year, the private sector has accumulated cash at rates unprecedented in modern history"

Following the GFC, much of the policy response was intended to recapitalise the financial system. As a result, a large amount of the monetary injections was soaked up by the banking system in the form of excess reserves. Between January 2008 and January 2010, excess reserves increased from essentially nothing to over $1trn – a figure even larger than the increase in the money supply during that period as the money supply 'only' grew by $700bn.

That excess reserves grew by more than the money supply implies that most of the monetary easing during this period did not reach the real economy and thus could have only limited impacts on inflation.

However, the post-COVID-19 situation is different. Because the nature of the policy response was very different this time, most of the money created has reached the real economy, which creates outcomes such as that shown below. Here we see that demand deposits (essentially everyday chequing accounts) in the US have grown by over $2trn (or 10% of US GDP) in the year to March 2021. Again, this rate of growth is unprecedented – the corresponding figure for 2009, for example, was negative and the largest increase in any calendar year post-GFC was less than 1% of US GDP.

Demand Deposit Growth: 2001-Present



Source: Bloomberg.

To put it very simply, over the past year, the private sector has accumulated cash at rates unprecedented in modern history.

Demand, meet supply

Although shocking in magnitude, even increases in money supply like these are insufficient to guarantee inflation, though they certainly make it more likely. This is because inflation is essentially a measurement of the relative balance of a quantity of money and the volume of goods upon which that money is spent. Or, to simplify, inflation is a reflection of supply and demand.

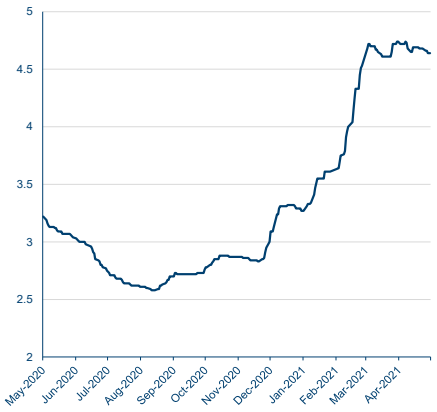
The above focus on money supply and private sector cash balances reflects the magnitude of demand while the anecdotal reports of pent-up demand waiting to be spent as lockdowns ease reflect the voracity of that demand (such as London pubs running out of beer). Such situations can possibly result in a demand pull inflationary situation whereby excess demand, or "too much money chasing too few goods", results in price spikes. However, if supply rises enough to meet this demand, no inflation may occur.

Therefore, to get a complete picture of inflationary risks, it is necessary to focus on the supply side of the economy as well. Unfortunately, here too the situation looks concerning.

In response to the onset of the COVID-19 pandemic, multiple industries witnessed significant reductions in output – occasionally from bankruptcies or intentional capacity reductions, but more commonly from production shutdowns or under-investment in inventories. The most widely discussed of these is the semiconductor industry but there are numerous other examples, such as lumber or metals – in all cases, customers dramatically cut orders and suppliers ran down inventories in the spring of 2020, only to see consumer demand prove resilient and supply chain shortages become acute. This has resulted in significant price spikes across most industries' supply chains, such as those shown below.

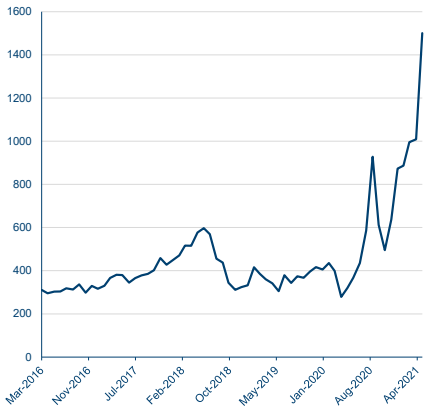
"In response to the onset of the COVID-19 pandemic, multiple industries witnessed significant reductions in output, [primarily] from production shutdowns or under-investment in inventories."

DRAM memory pricing



Source: Bloomberg.

Lumber Prices

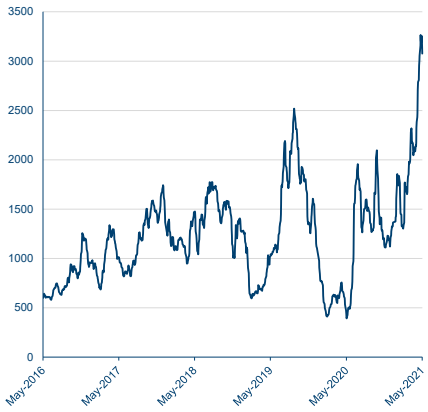


Source: Bloomberg.

Copper

Source: Bloomberg.

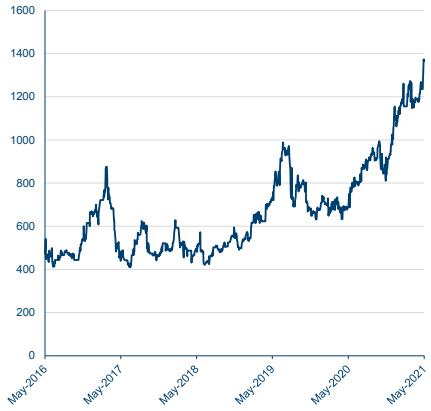
Bulk Shipping



Source: Bloomberg.

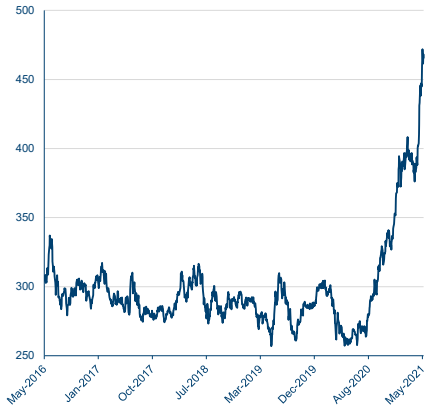
"We are currently in a very unusual state of affairs where both of the main cyclical inflationary forces are at play"

Iron Ore



Source: Bloomberg.

Agricultural Commodities



Source: Bloomberg.

Enter inflation

The above shows that we are currently in a very unusual state of affairs where both of the main cyclical inflationary forces are at play: demand pull, driven by eager consumers who are full of cash, and cost push, driven by supply chain shortages driving up production costs.

However, thankfully, wage pressures remain benign (for now) as the world is gradually reopening from lockdowns. This implies that consumer-facing cost increases should trail those facing producers as companies pass these price rises on with a lag. Or, in technical terms, we would expect to see producer prices rise before consumer prices.

That is precisely what we are seeing, as noted above. PPI at 9.5% in April is currently at 40-year highs whereas CPI was at 4.2% in April, merely a 10-year high.

Nonetheless, with unemployment being low and having recovered much of the COVID-19-related disruptions, it is unsurprising that labour market indicators suggest tightness, including a record 42% of US small businesses reporting a lack of workers in March and a record high in the US JOLT job openings rate[3].

The implications of this are seen in things such as McDonalds announcing that they will increase the wages of over 35,000 staff in the US by an average of 10% as they continue to face a "challenging hiring environment".

3. Source: National Federation of Independent Business and US Bureau of Labor Statistics. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital. It should not be assumed that recommendations made in future will be profitable or will equal performance of the securities in this document. A list of all recommendations made within the immediately preceding 12 months is available upon request.

This suggests that wage increases are more likely than not and that companies will have power to increase prices. As a result, we would expect consumer prices to rise faster in the coming months.

Summary and implications

In short, we see a multitude of inflationary risks:

- Unprecedented increases in monetary aggregates
- Record levels of consumer cash balances
- High levels of aggregate demand
- Supply chain disruptions leading to input price shocks

Taken together, these raise the risks for significant near-term inflationary overshoots. We have argued for some time that due to the sheer size of these forces, such inflationary spikes are far more likely than not.

What remains unknown is whether these temporary spikes would lead to a structural change in the inflationary environment (the rise of built-in inflation). Much depends on inflationary expectations – if consumers come to expect inflation, then self-fulfilling wage/price spirals can result.

We do not have an opinion on how likely this is, noting the risk of self-reinforcing feedback loops currently appears limited. In particular, we note that while inflation expectations have risen, those expectations reflect greater concern over short-term than long-term spikes as 5-year inflation breakevens are above 10-year breakevens, indicating that markets expect inflation to decline over time. Thus, while the question of structural inflation is unresolved, the market evidence for this is somewhat reassuring.

However, we believe that it is the near-term inflation environment that is most important for the outlook for markets and risk assets, rather than the open question of structural inflation. This is because the more short-term price spikes we see, and the greater the magnitude of these, the higher the likelihood that inflation can become ingrained. The presence of this risk, rather than the event itself, is sufficient to impact asset prices. To wit, the hyperinflation caused by the oil price shocks in the 1970s ultimately proved to be temporary, though that did not stop it from having dramatic effects on markets.

As inflationary expectations remain relatively low by historical standards, we believe they can rise materially. Given the sheer magnitude of the inflationary forces at play (as noted above) and how sanguine the Fed has been about addressing these, we believe there is a material risk that the near-term spikes in inflation could be significant, with multiple CPI prints over 5% possible and, perhaps, likely.

We do not believe that markets are priced for this possibility and consequently tail risk has grown for duration-sensitive assets.

That being said, we are also cognisant that monetary policy remains accommodative, fiscal policy remains hugely expansionary, real rates remain near all-time lows, and that all the inflationary forces we have mentioned above can also provide tailwinds to corporate earnings. Thus, asset pricing, especially in those sectors without inflationary headwinds, can continue to expand regardless of the path of near-term inflation.

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Market direction is therefore a complex question with multiple potential outcomes. We do not claim to have all the answers. Rather, we have written this simply to help inform as these dynamics are so powerful that it is incumbent upon all investors to understand them so they can make their own determination as to the most appropriate places to find the risk/reward opportunities that they require.

We hope we have been helpful in this regard.

David Sugarman,

Head of Convertible and Credit Research, Polar Capital

20 May 2021

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