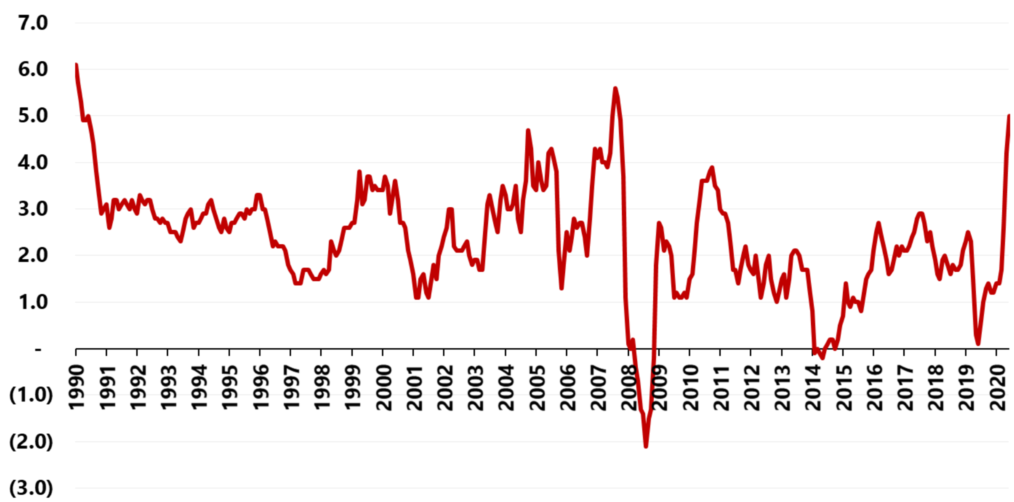
LC Monthly Investment Memo: June 2021

The US Consumer Price Index printed a shocking 5% year-on-year (Chart 1) for the month of May while China's Producer Price Index shot up above 10% year-on-year in June. As both the aforementioned readings have rarely been seen over the last 30 years, not a single day passes without an article on inflation in the financial press. Inflation is on everyone's lips and both camps (those who anticipate durable inflation and those who disagree) have strong arguments to back their views. With plausible explanations on each side by some of the most respectable portfolio managers in the industry, Lighthouse Canton's view is that "nobody knows, but we should soon find out ".

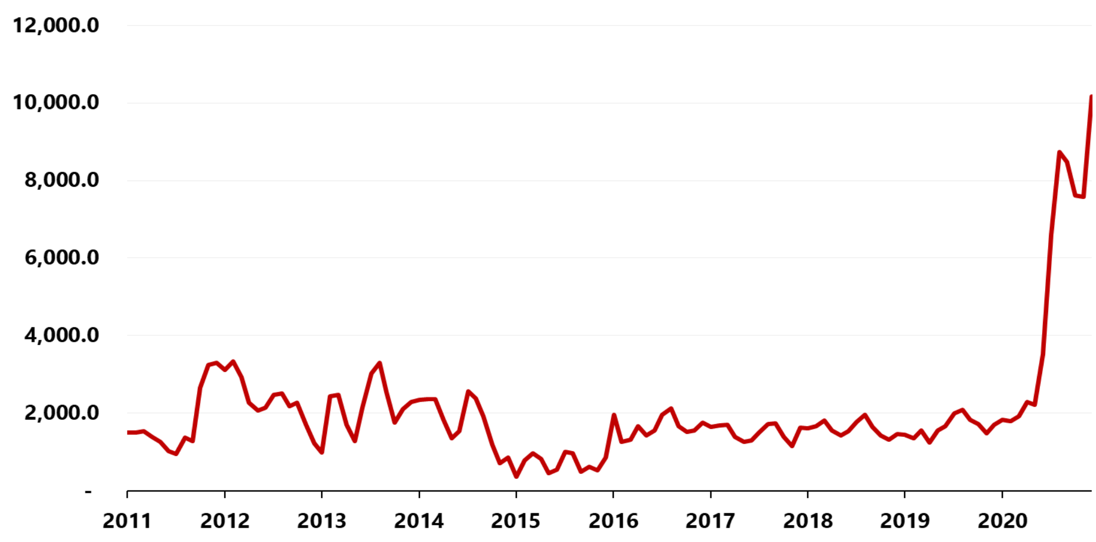
Chart 1: US Consumer Price Index year-On-year (%)



Source: Bloomberg

Economists who do not anticipate higher prices to become permanent often refer to long running deflationary forces to defend their views. According to Bridgewater's Prince, the rapid digitalization of economies worldwide as well as the relatively high unemployment levels in developed countries (e.g. 15% unemployment rate in Spain, US participation rate below 62%) should reduce pressure on prices over time. Prince also compares our current environment to that of the 1970s with a pinch of salt, mentioning that the strong credit growth, the energy shortage, and the strong labor unions of the 1970s are no longer in the picture. Thomas Hale from the Financial Times also illustrates that prices of goods have spiked recently because of the slowness in opening of ports and logistical hubs. This point can be validated as the price for a 40-foot container moved-up fivefold compared to its long-term average (Chart 2). Such bottlenecks are likely to evaporate in the coming quarters as more people get vaccinated and economies start to re-open.

Chart 2: WCI Shanghai to Rotterdam container freight rate per 40-foot box (USD)

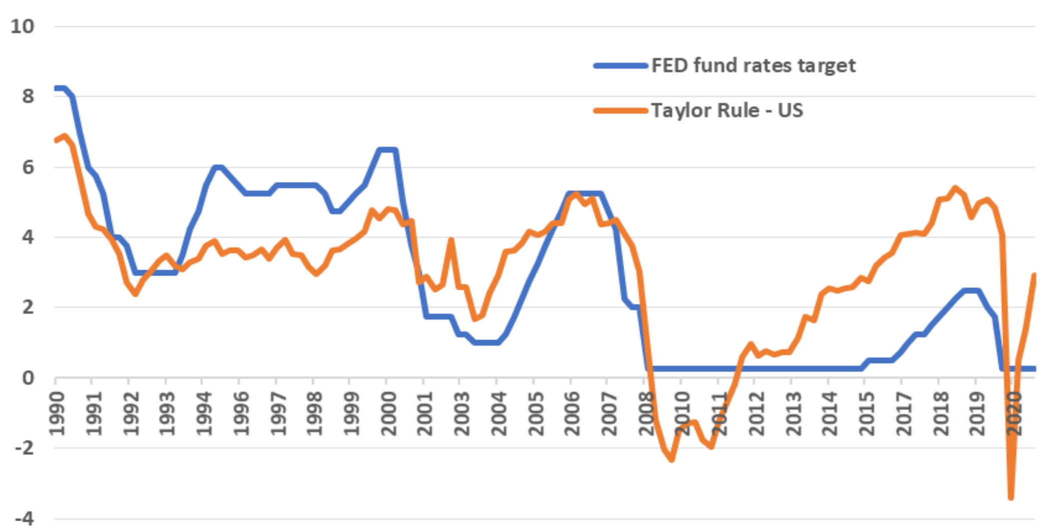


Source: Bloomberg

On the other hand, investors and economists who anticipate higher inflation going forward also have reasonable arguments. Micro-chips shortage, higher wages (e.g. Amazon minimum wage at US$15/hour in the US *(Source: Business Insider article "Amazon is establishing a new minimum wage in America" dated 25th May 2021))* and housing tightness has already pushed the price of many goods higher. Once accepted by end-consumers, the chances to see these prices recede to pre-Covid levels are close to nil. Moreover, the pandemic brought to light the shortage of several strategic products such as medicinal drugs, where the production of these products had been outsourced to lower-cost countries, one would expect this now to be relocated to the US and Europe, which will inevitably increase their production-cost. On a longer-term horizon, China's transition from being a global manufacturer to a global consumer could also have permanent ramifications on the long-term supply gap.

Consequently, inflation expectations may become unanchored, which could be devastating when looking at the record-high valuations of most asset classes. For these reasons, a lot of investors now consider that the central banks' decision of not adopting appropriate or timely policies has become the main risk. Economists also refer to the Taylor rule, a formula that can be used to predict or guide how central banks should alter interest rates due to changes in the economy, as a good illustration of our current situation (Chart 3). Whereas keeping rates close to flat for several years during the lengthy "U-shape" recovery of the Great Financial Crisis (GFC) made a lot of sense, it would be a mistake to apply the same loose monetary policy during a V-shape recovery as it would inevitably fuel market bubbles.

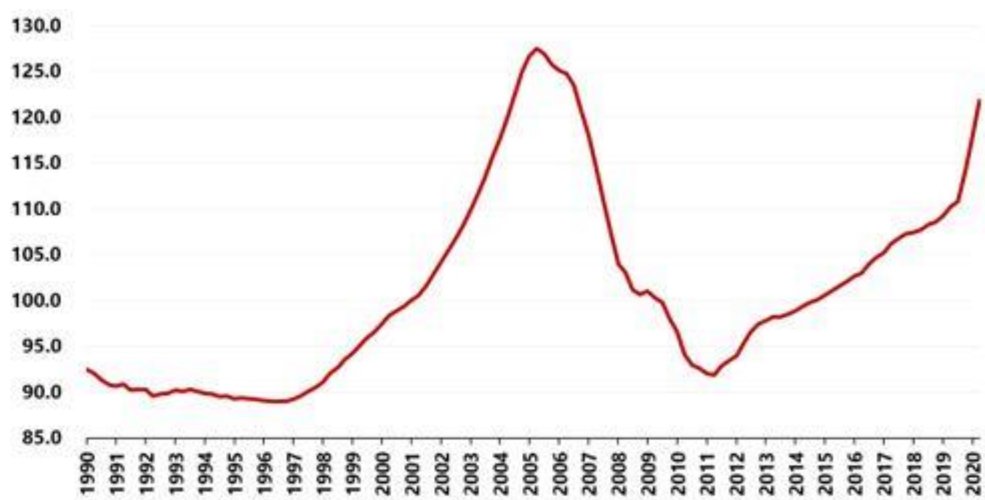
Chart 3: US Taylor Rule points to rates theoretically close to 3%



Source: Bloomberg

Speaking of market bubbles, several orange flags have caught our attention recently. To start, the recent spike in overnight repo transactions in the US to above $750bn (which is now at the highest point since the start of its monitoring in 2013) as stated in the *MarketWatch article titled "Fed's reverse repo program sees demand soar to just under $1 trillion overnight" dated 30th June 2021*, indicates that US banks currently have too much cash on hand. On the same register, Dogecoin which started as a joke in 2013 is now valued at approximately $30bn on *CoinMarketCap as of 30th June 2021*. Not bad for "a joke" you can't do much with. What is even more worrying is the price-to-rent ratio, used in real estate to gauge the dearness of the market, has accelerated over the last 12 months close to pre-GFC level in the US (Chart 4).

Chart 4: US house price-to-rent ratio



Source: Bloomberg

Additionally, we are witnessing a new form of market manipulation by retail investors around so-called "meme stocks". For retail investors, the strategy is purely speculative (rather than driven by fundamentals) where this involves pilling into a stock, all at the same time, to drive its price several times higher before quickly taking profits at the top to invest in another "meme" stock. The speculative nature of these trades not only has resulted in retail investors to incur huge losses in their investment when they got their "timing" wrong but also short squeezed the positions of the more sophisticated investors.

The most recent example is the recent rally of AMC Entertainment share price. Despite its business having suffered heavy losses during the Covid period and the already weak fundamentals remaining unchanged, its share price shot up multiple folds from its pre-Covid days (Chart 5) as retail investors piled into stocks which offers high short interest and potential for growth on the back of economy re-opening. Once again, institutional investors who trade based on fundamentals, were short squeezed on their positions and were left with no choice but to buy the stock to cover their short positions. While many sophisticated investors view this as another clear sign of a market that has lost touch with reality, the regulators seemed to have a "laissez-faire" attitude towards this new phenomenon and have turned a blind eye.

Chart 5: AMC Entertainment share price since 2015

Source: Bloomberg

As mentioned in the introduction, a lot of canny investors have shared their argument on the state of inflation. Since most of them agree that asset prices look expensive wherever you look, in our opinion the point is less about where inflation will settle but more about how to prepare portfolios should inflation turn sticky. Indeed, even if inflation were to remain under control, a BarCap US Corporate High Yield index offering a paltry 2.33% or an S&P 500 index which is currently trading at 35x its earning, probably only offer limited upside going forward. On the opposite, should inflation settle above the 2% long term target, then central bankers will have no choice but to (re)act through raising interest rates. Tackling potential inflation in an orderly manner, i.e. without popping the multiple bubbles, will be the biggest challenge faced by central bankers since Bretton Woods.

In such an uncertain environment especially where we deem valuations as unsustainable, Lighthouse Canton continues to focus on managing the downside risk of a portfolio by reducing its overall beta through diversification.

Yours Faithfully,

The Lighthouse Canton Team