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Hosking Post
New World Order?

April 2022

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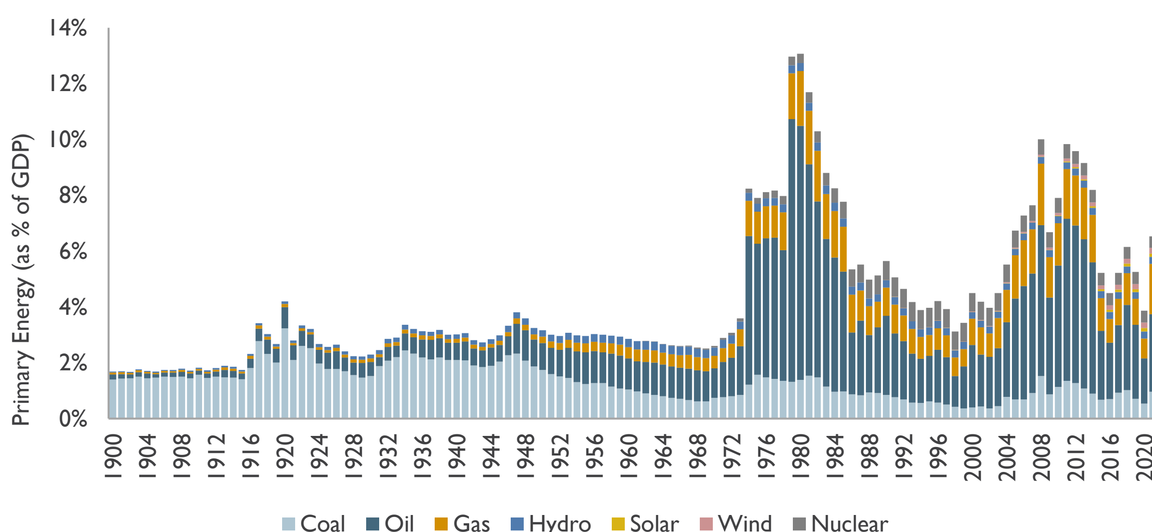
NEW WORLD ORDER?

The tragedy unfolding in Eastern Europe has brought to life an observation attributed to Leon Trotsky "you may not be interested in war, but war is interested in you". The Russian invasion of Ukraine has caused untold human misery. Referencing its impact to the investment outlook feels callous. That said, it is part of the fund manager job spec to take the broader view, and it now seems a possibility that the war in Ukraine bookends the GFC-to-Covid chapter for global equity markets. The last dozen years have advantaged investment styles predicated on declining long-term interest rates, low inflation, abundant liquidity and an ever more efficient global supply chain. Most starkly, the war, and its disruption to energy supplies, upends an optimistic consensus around the costs involved in the transition to net zero. It is becoming increasingly clear that we simply do not have enough energy and resource supply to make the transition cheaply. Shakespeare's idiom "thy wish was father, Harry, to that thought" rings in our ears.

The main impact of the war has been to accelerate turning points which came into view during the Covid-era. These trends are now well established and this piece modestly puts forward five accelerating "realities" of the post-Ukraine invasion world:

1. Inflation is not transitory - and as the energy crisis attests, it is unwelcome. Interest rates are going to rise to levels that will test years (decades?) of positive reinforcement around the Fed-put.
2. The cost of capital is rising. Trends in existing industry capital cycles - many of which reached turning points during the Covid pandemic - will be amplified by higher interest rates. Prior decade winners are most at risk, and vice versa.
3. Energy and commodity shortages are real. Years of fossil fuel and mining sector under-investment have led to supply-led price rises that will take years to unwind. The consensus around the energy transition was built in an era of cheap money <u>and</u> cheap energy. This will be tested as rising energy and commodity prices squeeze incomes.
4. Geopolitical spheres of influence will curtail corporate capex and institutional investment flows. The severity of Russian sanctions and capital market fall-out will re-price capital and limit flows between aligned and non-aligned countries.
5. Global supply chains are being reconfigured. The double whammy of Covid and the Ukraine invasion is unpicking years of ever-more-efficient global supply chains. Corporate profitability – particularly for 'global champion' multinational companies – may have peaked.

Should this interest rate tightening cycle play out as per treasury market expectations it will coincide with the worst energy supply crisis in living memory[1]. Whilst not professing any special skills in "Fed watching" it would appear to this bystander that the Fed is not going to blink. It is set to hike rates – in 50bps increments - into an economy dealing with $100+ oil prices and record consumer energy bills. Energy supply is not growing fast enough to meet demand and while renewables are an obvious part of the solution they will not be available in the volume needed for a long time, and in the short term their roll-out may consume more energy than they generate. As a result, prices are rising and energy costs in the US are forecast to be over 13% of GDP in 2022, an extreme level reached only once in the mid-1970s (see chart below).



Source: Thunder Said Energy.

The long-held consensus - that our over-indebted world cannot handle interest rates much above 2.5% - is set to be tested. With current US CPI running at 7.9% it may be that we look back and say "What were we thinking? How could rates have stayed so low, for so long?".

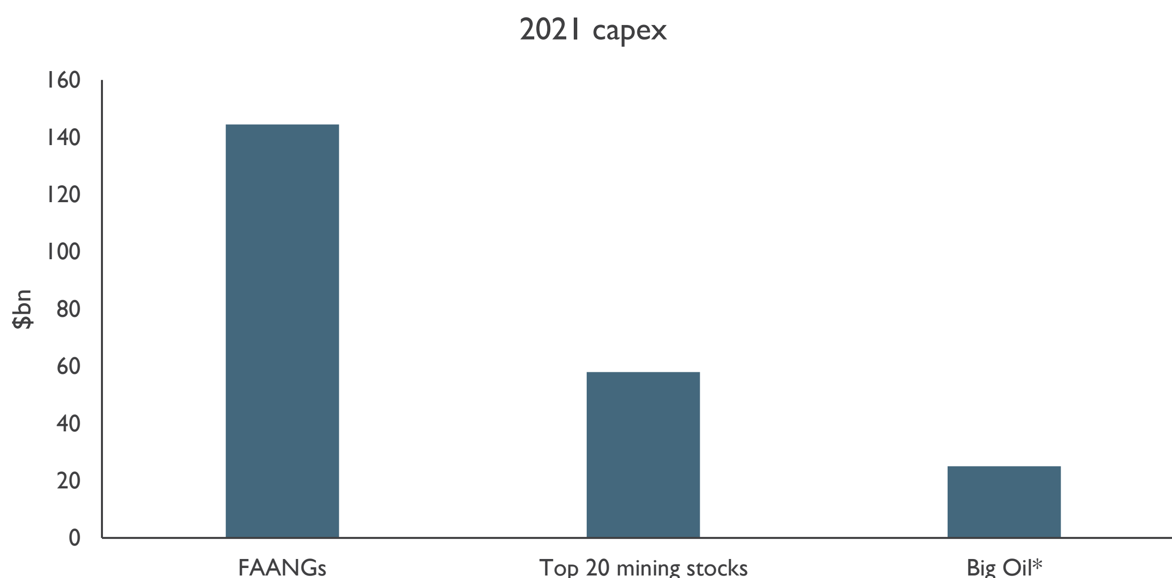
We can gain some insight into the implications of the tightening cycle by looking at the equity market reaction to the initial stage of the interest rate reset – rising long-term rates reflecting the unwind of pandemic monetary largesse. The 50%-75% corrections in speculative tech stocks over the past 9 to 12 months mark a pivot in the technology capital cycle. Not only will fast growing, cash-consuming listed companies find access to capital more difficult as rates rise but the venture capital-backed private companies – who rely on high public company benchmark valuations – face the dreaded spiral of "down rounds", the recent 40% decline in Instacart being the first of many. In reviewing the

1 The Treasury market implies 7x 25bps hikes in short term in the next 12m, taking short term interest rates to just over 2%.

2000s tech crash, Alasdair Nairn in his masterful text "Engines that move Markets; Technology Investing from Railroads to the Internet and Beyond" makes the simple point that as the tide turned it was access to capital that determined corporate longevity.

"As in other technology cycles companies that lacked continued access to capital or could not reach self-sustaining cash flow fast enough risked seeing their market positions swiftly competed away. The first mover advantage that so exercised the early pioneers frequently proved to be a mirage."

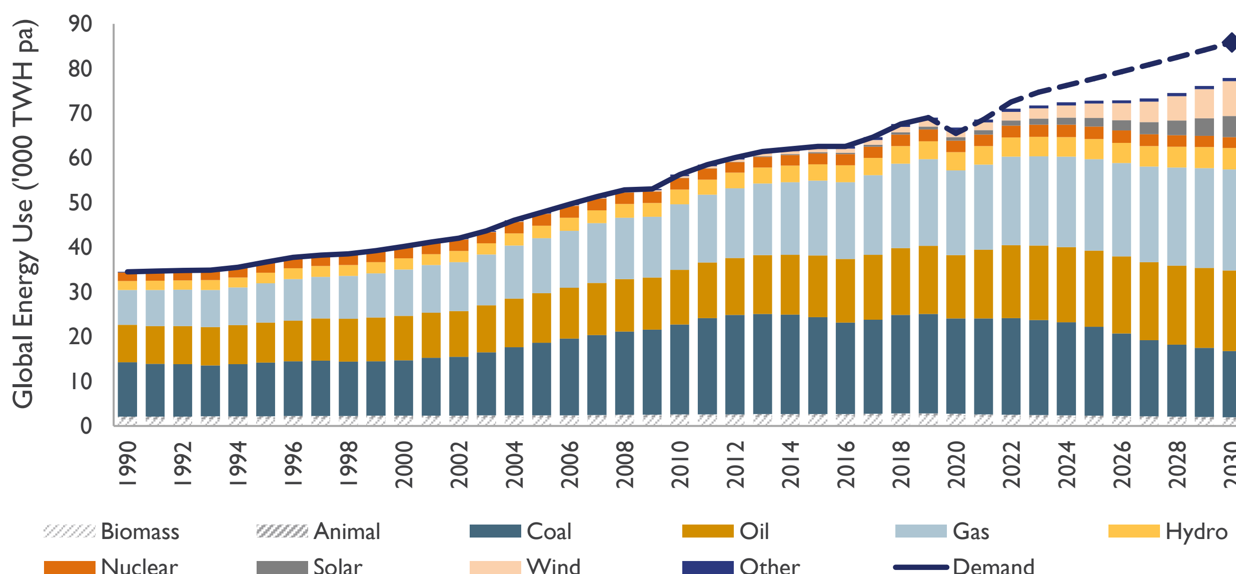
As we move into the next stage of the Fed tightening cycle the hitherto resilient Big Tech may come under pressure. These companies, traditionally identified as the FAANGs, which unlike many Unicorns are prodigious cash generators, are nevertheless entering a capex cycle at just the point that capital is re-priced upwards. In the last decade FAANG capex spend has doubled from 5.5% of sales to 10% - a measure approximately double that of the S&P 500. In 2021 the FAANGs spent $144bn on capex. This is more than double the top 20 global mining companies combined and over five times that of a combined Exxon, Chevron and ConocoPhillips. As the FAANG companies grow ever larger, the law of large numbers sees them increasingly competing against each other, as the fall out around Apple's IOS privacy setting demonstrated.



*Source: FactSet. * Chevron, Exxon, ConocoPhillips.*

On the flip side, the capital cycle in resource and energy companies has turned demonstrably positive. Years of ESG pressure, combined with capex discipline, has seen compressed new supply. Prior to the invasion of Ukraine, the world had a 2% negative energy supply-demand imbalance.

This sounds like a small number but commodity markets are made at the margin. Russian sanctions compound this situation and lead to higher returns for those resource extraction incumbents – BP CEO Bernard Looney recently referred to BP as a "cash machine" at the current oil price. Many of these companies now have management incentive schemes that are aligned with shareholder returns and carbon priorities rather than growth in supply. It is unlikely that we will immediately see the sort of swift supply response we have seen in prior upswings. According to the investment bank Jefferies, mining capex per unit of mine production is 40% below the 1992 level. And these are the materials required to electrify the grid to take us to net zero! As the energy transition meets this reality commodity prices will remain high until supply, or in the case of a recession, demand, returns to balance.



Source: Eurostate, Thunder Said Energy. 28 Feb 2022.

For Western energy and resource companies this is positive. However, for companies based in, or with assets located in the China-Russia sphere of influence, they are now hit with a double cost of capital increase. This has been driven home by the evisceration of equity value in not just the Russian equity market but in the significant impairment seen by many companies that do business in or with Russia. Whether the continued underperformance of the Chinese equity market is in part driven by this trend will be a question for market historians, but it seems likely that the cost of equity for any China-related equity is rising post-Ukraine. Likewise, for companies who have relied on hyper-efficient global supply chains a major capex hump beckons. Reengineering global supply chains – many of which will need to move much closer to primary energy sources – will of course

consume time and money but will also require a psychological reset for the generation of executives who have been taught globalization at leading businesses schools.

Where does this leave the Hosking Partner's portfolio?

Of the five trends outlined above, we were wrongfooted by the accelerated arrival of the "spheres of influence" reality. Around 4% of the model portfolio was invested in Russian-related equities at the start of this year. This has been written down to zero following the tragic events in Ukraine and will not, obviously, benefit from the higher oil prices which, all else being equal, one would have anticipated from our Russian exposure. The remaining trends, all solidified during the Covid pandemic, are well represented in the portfolio. The interest rate cycle benefits very few areas of the stock market save our largest sector exposure - financials, which represents just under a quarter of the portfolio. We have been consistent that the self-help, cost-driven story in this consolidating and digitizing industry does not need rising rates to deliver acceptable returns. But returns could be super-charged should this rate cycle be a success. The capital cycle in the commodity and energy sector (at around 18% of the portfolio) remains the second largest theme and stands to benefit from a multi-year period of elevated pricing. And whilst as a firm we believe the cure for high prices is high prices, we don't see a meaningful supply response anytime soon. As outlined in the Hosking Post **"Tandem – At Length, or How Long is the Cycle"**, we believe this cycle is going to be long-lived. Indeed, the policy response is likely to mirror the UK's infamous "Help to Buy" scheme – which instead of addressing the root cause of high UK house prices (the supply of housing) actually propped up prices by subsidizing buyers. We therefore expect fuel vouchers to be a theme of the coming years. Moreover, it will take a long time for the ESG-driven constraints on new supply which have emerged over the past decade to unwind.

Whilst conscious that a major recession is an obvious risk to our portfolio view – and the recent yield curve inversion raises this prospect – the irresistible turn of the capital cycle in much of the growth areas of the stock market gives us comfort that we are well positioned come what may. Indeed, of the top 25 performing stocks year-to-date in the S&P500, all but one (Nielsen) pull 'stuff' out of the ground. The trends appear firmly established and as one of Hosking Partners' retained strategists David Scott likes to point out, "events don't change trends they just accelerate them".

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April 2022

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